64PR

Direct line: 602-542-0193
Facsimile: 602-594-7476
E-mail: cf@ccsd.cc.state.az.us

MEMORANDUM

TO: Lyn Farmer, Chief Administrative Law Judge
Hearing Division

FROM: Cheryl T. Farson, General Counsel
Securities Division

DATE: July 23, 2002

RE: A.A.C. R14-4-132
Docket No. RS-00000A-02-0005

Attached for your review in connection with a proposed amendment to A.A.C. R14-4-132 ("rule 132") are the following:

- Rule 132 with amendments highlighted.
- The Economic, Small Business, and Consumer Impact Statement prepared by the Division in connection with the proposal.
- Regulations incorporated by reference into rule 132.
  - 17 CFR 240.17a-3 (2002) as amended by 66 Fed. Reg. 55817 (2001)
  - 17 CFR 240.17a-4 (2002) as amended by 66 Fed. Reg. 55817 (2001)
  - 17 CFR 240.15g (2002)
  - 17 CFR 240.15c2-11(2002)

Also attached is a draft proposed order.

Procedural history

Docket RS-00000A-02-0005 was opened January 4, 2002, and the Notice of Rulemaking Docket Opening was published February 1, 2002, in Volume 8, Issue 5, Page 494. The proposed amendment was informally circulated to the office of the attorney general, Securities Division

staff, and local private bar members for comment. The Division received two letters from the private bar in connection with that circulation, copies of which are in the record.

At an open meeting on April 25, 2002, the Commissioners ordered the publication of a Notice of Proposed Rulemaking, Order No. 64788, signed May 1, 2002. The Notice of Proposed Rulemaking was published May 24, 2002, Volume 8, Issue #21, Page 2221. The Division notified industry members and the private bar regarding the publication of the Notice of Proposed Rulemaking and posted notice of the publication on the Division's web site. The statutory time period required for public comment ended June 24, 2002. The Division received no comments, written or oral. The Division received no request for oral proceedings and does not recommend that a hearing be held.

The Division requests that the Hearing Division submit a proposed order to the Commission that recommends that the Commission approve the rule amendment and order that the rulemaking be forwarded to the office of the attorney general for approval pursuant to A.R.S. § 41-1044.

Background regarding rule 132

Rule 132 requires that registered dealers make, maintain, and preserve books and records in compliance with certain specified U.S. Securities and Exchange Commission ("SEC") rules, including 17 CFR 240.17a-3 and 17 CFR 240.17a-4. The SEC has amended 17 CFR 240.17a-3 and 17 CFR 240.17a-4. The amendments will be effective May 2, 2003. The Division proposes that the amendment to rule 132 become effective the later of the effective date of the amendments reflected in SEC Release No. 34-44992 or the date pursuant to A.R.S. § 41-1032.

The SEC's books and records rules, promulgated under the Securities Exchange Act of 1934, specify minimum requirements with respect to the records that dealers must make, and how long those records and other documents relating to a dealer's business must be kept. The SEC has required that dealers create and maintain certain records so that, among other things, the SEC, self-regulatory organizations, and state securities regulators may conduct effective examinations of dealers.

The National Securities Market Improvement Act of 1996 ("NSMIA") prohibits states from establishing books and records rules that differ from, or are in addition to, the SEC's books and records rules. Specifically, section 15(h)(1) of the federal Securities Exchange Act of 1934 (15 U.S.C. § 78o(h)(1)), adopted in NSMIA, provides that

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish . . . making and keeping records . . . requirements for . . . dealers . . . that differ from, or are in addition to, the requirements in those areas established under this title.

The Division proposes amending rule 132 to reflect the federal law mandate that state books and records requirements do not differ from the SEC books and records rules and to reflect the SEC's amendments, which will become effective May 2, 2003.

If you have any questions or require additional information, please do not hesitate to contact me.

R14-4-132. Books and Records of Dealers

A. Unless otherwise provided by order of the Commission, each registered dealer shall make, maintain, and preserve books and records in compliance with U.S. Securities and Exchange Commission rules 17a-3 (17 CFR 240.17a-3 (~~1991~~2002)~~;~~ and 17-a4 (17 CFR 240.17a-4 (~~1991~~2002)) as amended in Release No. 34-4992, 66 Fed. Reg. 55817 (2001);~~;~~ ~~15c2-6~~ 15g (17 CFR ~~240.15c2-6 (1991~~240.15g (2002))~~;~~; and 15c2-11 (17 CFR 240.15c2-11 (~~1991~~2002), ~~as amended in Release No. 34-29094, 56 Fed. Reg. 19148 (1991))~~ all of which are incorporated ~~herein~~ by reference. Copies of the materials are available from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402, from the Commission, and are on file with the office of the secretary of state.

B. To the extent that the U.S. Securities and Exchange Commission promulgates changes to the above-referenced rules, dealers in compliance with such rules as amended shall not be subject to enforcement action by the Commission for violation of this rule to the extent that the violation results solely from the dealer's compliance with the amended rule.

Arizona Corporation Commission, Securities Division
Chapter 4, Corporation Commission—Securities
Article 1. In General Relating to the Arizona Securities Act

Economic, Small Business, and Consumer Impact Statement

A. Economic, small business, and consumer impact summary.

1. Proposed rulemaking.

The Arizona Corporation Commission (the "Commission") amends A.A.C. Section R14-4-132 ("rule 132").

2. Summary of information included in this economic, small business, and consumer impact statement.

The economic, small business, and consumer impact statement for rule 132 incorporates by reference SEC Release No. 34-44992; File No. S7-26-98, which analyzes the costs, savings, and benefits of amendments to the federal books and records requirements. This analysis is relevant to the Commission's amendment of rule 132 because, by federal mandate, rule 132 parallels federal law.

Section 15(h)(1) of the federal Securities Exchange Act of 1934 (15 U.S.C. § 78o(h)(1)), adopted in 1996, provides that

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish . . . making and keeping records . . . requirements for . . . dealers . . . that differ from, or are in addition to, the requirements in those areas established under this title.

The SEC has amended two of the rules incorporated in rule 132; the amendments will be effective May 2, 2003. The Commission amends rule 132 to reflect the federal

law mandate that state books and records requirements do not differ from the SEC books and records rules and to reflect the SEC's amendments effective May 2, 2003.

3. Name and address of agency employees who may be contacted to submit or request additional data on the information included in this statement.

Cheryl T. Farson
Securities Division
Arizona Corporation Commission
1300 W. Washington, Third Floor
Phoenix, AZ 85007

B. Economic, small business, and consumer impact statement

The Arizona Corporation Commission (the "Commission") has not conducted any study and is not aware of any study that measure the cost of implementation or compliance with the rules promulgated under the Arizona Securities Act (the "Securities Act"). The time and dollar expenditures necessary to obtain such data are prohibitive. Adequate data, therefore, is not reasonably available to provide quantitative responses to the items required under A.R.S. § 41-155(B).

The Commission incorporates by reference Securities and Exchange Commission ("SEC") Release No. 34-44992, 66 Fed. Reg. 55817 (2001) ("SEC release no. 34-44992"), which describes the SEC's rulemaking process in connection with federal amendments to the SEC books and records requirements; the amendments; the costs and benefits of the amendments; the effects on efficiency, competition, and capital formation; and a summary of a Final Regulatory Flexibility Analysis. A copy of SEC release no. 34-44992 is attached.

1. Proposed rulemaking.

The Commission amends A.A.C. R14-4-132 ("rule 132") in order to comply with federal law. Prior to amendment, rule 132 required that registered dealers make, maintain,

and preserve books and records in compliance with certain specified SEC rules as those rules existed in 1991. Pursuant to A.R.S. § 44-1028, the 1991 SEC books and records rules were incorporated by reference and did "not include any later amendments or editions of the incorporated matter."

Section 15(h)(1) of the federal Securities Exchange Act of 1934 (15 U.S.C. § 78o(h)(1)), adopted in 1996, provides that

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish . . . making and keeping records . . . requirements for . . . dealers . . . that differ from, or are in addition to, the requirements in those areas established under this title.

The SEC has amended two of the rules incorporated in rule 132; the amendments will be effective May 2, 2003. The Commission amends rule 132 to reflect the federal law mandate that state books and records requirements do not differ from the SEC books and records rules and to reflect the SEC's amendments effective May 2, 2003.

2. Persons who will be directly affected by, bear the costs of, or directly benefit from the proposed rulemaking.

Those affected by rule 132 include persons that offer, buy, or sell securities as those terms are defined by the Securities Act. Specifically, Arizona dealers are required to make, maintain, and preserve books and records regarding the conduct of their business. During the fiscal year 2001, the Commission registered approximately _____ dealers.

Cost bearers.

The costs of compliance with rule 132 will be borne directly by the regulated persons. The costs of enforcement of rule 132 will be borne by the Commission and the

office of the attorney general. The costs of implementation of the proposed rulemaking will be borne by the Commission.

Beneficiaries.

The industry, the Commission, and the public will benefit from the rule amendments.

The Commission will benefit because "[t]he enhanced recordkeeping requirements would help make available critical information necessary for securities regulatory authorities to discover and take appropriate action for various securities violations, particularly sales practice violations. The cost to securities regulatory authorities to obtain the same information and evidence that otherwise would be available by these rules from other methods would be high. In addition, the possibility exists that government regulatory authorities would be unable to obtain certain information by any other means if the information is not required to be kept. Investigatory delays often lead to additional investor losses." SEC release no. 34-44992, section VIII. The public will benefit from the Commission's enhanced ability to monitor dealer compliance with the Arizona Securities Act.

The industry will benefit because, "[a]s one commenter stated, 'the cost savings to industry of moving from compliance in the pre-NSMIA days with a variety of State laws to a new uniform should be equally substantial and should more than make up for any [additional] burden imposed by the [amendments].' The uniformity provided by NSMIA and these amendments to Rules 17a-3 and 17a-4 should result in significant cost savings to broker-dealers that operate in multiple jurisdictions." SEC release no. 34-44992, section XIII.A.

3. Cost/benefit analysis.

a. Cost/benefit analysis of the probable costs and benefits to the implementing agency and other agencies directly affected by the implementation and enforcement of the proposed rulemaking.

See SEC release no. 34-44992 incorporated herein by reference, section VIII.

b. Cost/benefit analysis of the probable costs and benefits to a political subdivision of this state directly affected by the implementation and enforcement of the proposed rulemaking.

None.

c. Cost/benefit analysis of the probable costs and benefits to businesses directly affected by the proposed rulemaking, including any anticipated effect on the revenues or payroll expenditures of employers who are subject to the proposed rulemaking.

See SEC release no. 34-44992 incorporated herein by reference, section VIII.

4. General description of the probable impact on private and public employment in businesses, agencies, and political subdivisions of this state directly affected by the proposed rulemaking.

The Commission anticipates that the impact of the rulemaking on public and private employment will be minimal because most dealers already maintain the books and records required under the rule as amended. See SEC release no. 34-44992, section VIII, footnotes 95 and 96 and related text; section X.C.

5. Statement of the probable impact of the proposed rulemaking on small businesses.

a. An identification of the small businesses subject to the proposed rulemaking.

See SEC release no. 34-44992 incorporated by reference, section X.B.

b. The administrative and other costs required for compliance with the proposed rulemaking.

See SEC release no. 34-44992 incorporated by reference, section VIII.

c. A description of the methods that the agency may use to reduce the impact on small businesses.

See SEC release no. 34-44992 incorporated by reference, section X.B.

d. The probable cost and benefit to private persons and consumers who are directly affected by the proposed rulemaking.

Nonregulated persons and consumers will bear no direct cost as a result of the proposed rulemaking package. Persons participating in securities transactions will benefit from the regulation of, and imposition of standards on, securities dealers.

6. Statement of the probable effect on state revenues.

The Commission anticipates that the rulemaking will have no direct effect on state revenues.

7. Description of any less intrusive or less costly alternative methods of achieving the purpose of the proposed rulemaking.

The goal of the proposed rulemaking is to effectuate the least intrusive and costly method of regulation of dealers required to achieve the statutorily mandated level of public protection. Because of the federal mandate for uniformity, in this instance the Commission has no alternative method of imposing books and records requirements.

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[CITE: 17CFR240.17a-3]

[Page 389-397]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a) Every member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange, and every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to section 15 of the

[[Page 390]]

Securities Exchange Act of 1934, as amended, (48 Stat. 895, 49 Stat. 1377, 52 Stat. 1075; 15 U.S.C. 78o) shall make and keep current the following books and records relating to his business:

(1) Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.

(2) Ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.

(3) Ledger accounts (or other records) itemizing separately as to each cash and margin account of every customer and of such member, broker or dealer and partners thereof, all purchases, sales, receipts and deliveries of securities and commodities for such account and all other debits and credits to such account.

(4) Ledgers (or other records) reflecting the following:

(i) Securities in transfer;

(ii) Dividends and interest received;

(iii) Securities borrowed and securities loaned;

(iv) Moneys borrowed and moneys loaned (together with a record of the collateral therefor and any substitutions in such collateral);

(v) Securities failed to receive and failed to deliver;

(vi) All long and all short securities record differences arising from the examination, count, verification and comparison pursuant to Sec. 240.17a-5, Sec. 240.17a-12, and Sec. 240.17a-13 (by date of examination, count, verification and comparison showing for each security the number of long or short count differences);

(vii) Repurchase and reverse repurchase agreements;

(5) A securities record or ledger reflecting separately for each

security as of the clearance dates all ``long'' or ``short'' positions (including securities in safekeeping and securities that are the subjects of repurchase or reverse repurchase agreements) carried by such member, broker or dealer for his account of for the account of his customers or partners or others and showing the location of all securities long and the offsetting position to all securities short, including long security count differences and short security count differences classified by the date of the physical count and verification in which they were discovered, and in all cases the name or designation of the account in which each position is carried.

(6) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. Such memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time of entry, the price at which executed and, to the extent feasible, the time of execution or cancellation. Orders entered pursuant to the exercise of discretionary power by such member, broker or dealer, or any employee thereof, shall be so designated. The term ``instruction'' shall be deemed to include instructions between partners and employees of a member, broker or dealer. The term ``time of entry'' shall be deemed to mean the time when such member, broker or dealer transmits the order or instruction for execution or, if it is not so transmitted, the time when it is received.

(7) A memorandum of each purchase and sale for the account of such member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.

(8) Copies of confirmations of all purchases and sales of securities, including all repurchase and reverse repurchase agreements, and copies of notices of all other debits and credits for securities, cash and other items for the account of

[[Page 391]]

customers and partners of such member, broker or dealer.

(9) A record in respect of each cash and margin account with such member, broker or dealer indicating (i) the name and address of the beneficial owner of such account, and

(ii) Except with respect to exempt employee benefit plan securities as defined in Sec. 240.14a-1(d), but only to the extent such securities are held by employee benefit plans established by the issuer of the securities, whether or not the beneficial owner of securities registered in the name of such members, brokers or dealers, or a registered clearing agency or its nominee objects to disclosure of his or her identity, address and securities positions to issuers, and (iii) in the case of a margin account, the signature of such owner; Provided, That, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account.

(10) A record of all puts, calls, spreads, straddles and other options in which such member, broker or dealer has any direct or indirect interest or which such members, broker or dealer has granted or guaranteed, containing, at least, an identification of the security and the number of units involved. An OTC derivatives dealer shall also keep a record of all eligible OTC derivative instruments as defined in Sec. 240.3b-13 in which the OTC derivatives dealer has any direct or indirect interest or which it has written or guaranteed, containing, at

a minimum, an identification of the security or other instrument, the number of units involved, and the identity of the counterparty.

(11) A record of the proof of money balances of all ledger accounts in the form of trial balances, and a record of the computation of aggregate indebtedness and net capital, as of the trial balance date, pursuant to Sec. 240.15c3-1; Provided, however, (i) That such computation need not be made by any member, broker or dealer unconditionally exempt from Sec. 240.15c3-1 by paragraph (b)(1) or (b)(3), thereof; and (ii) that any member of an exchange whose members are exempt from Sec. 240.15c3-1 by paragraph (b)(2) thereof shall make a record of the computation of aggregate indebtedness and net capital as of the trial balance date in accordance with the capital rules of at least one of the exchanges therein listed of which he is a member. Such trial balances and computations shall be prepared currently at least once a month.

(12)(i) A questionnaire or application for employment executed by each ``associated person'' (as hereinafter defined) of such member, broker or dealer, which questionnaire or application shall be approved in writing by an authorized representative of such member, broker or dealer and shall contain at least the following information with respect to such person:

(a) His name, address, social security number, and the starting date of his employment or other association with the member, broker or dealer;

(b) His date of birth;

(c) A complete, consecutive statement of all his business connections for at least the preceding ten years, including whether the employment was part-time or full-time;

(d) A record of any denial of membership or registration, and of any disciplinary action taken, or sanction imposed, upon him by any federal or state agency, or by any national securities exchange or national securities association, including any finding that he was a cause of any disciplinary action or had violated any law;

(e) A record of any denial, suspension, expulsion or revocation of membership or registration of any member, broker or dealer with which he was associated in any capacity when such action was taken;

(f) A record of any permanent or temporary injunction entered against him or any member, broker or dealer with which he was associated in any capacity at the time such injunction was entered;

(g) A record of any arrest or indictment for any felony, or any misdemeanor pertaining to securities, commodities, banking, insurance or real estate (including, but not limited to, acting or being associated with a broker-dealer, investment company, investment adviser, futures sponsor, bank, or savings and loan association), fraud, false statements or omissions,

[[Page 392]]

wrongful taking of property or bribery, forgery, counterfeiting or extortion, and the disposition of the foregoing.

(h) A record of any other name or names by which he has been known or which he has used;

Provided, however, That if such associated person has been registered as a registered representative of such member, broker or dealer with, or his employment has been approved by, the National Association of Securities Dealers, Inc., or the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Coast Stock Exchange, or the Philadelphia-Baltimore Stock Exchange, then retention of a full, correct, and complete copy of any

and all applications for such registration or approval shall be deemed to satisfy the requirements of this paragraph.

(ii) For purposes of this paragraph (a)(12) the term associated person shall mean a partner, officer, director, salesman, trader, manager, or any employee handling funds or securities or soliciting transactions or accounts for such member, broker or dealer.

(13) Records required to be maintained pursuant to paragraph (d) of Sec. 240.17f-2.

(14) Copies of all Forms X-17F-1A filed pursuant to Sec. 240.17f-1, all agreements between reporting institutions regarding registration or other aspects of Sec. 240.17f-1, and all confirmations or other information received from the Commission or its designee as a result of inquiry.

(15) Records required to be maintained pursuant to paragraph (e) of Sec. 240.17f-2.

(16)(i) The following records regarding any internal broker-dealer system of which such a broker or dealer is the sponsor:

(A) A record of the broker's or dealer's customers that have access to an internal broker-dealer system sponsored by such broker or dealer (identifying any affiliations between such customers and the broker or dealer);

(B) Daily summaries of trading in the internal broker-dealer system, including:

(1) Securities for which transactions have been executed through use of such system; and

(2) Transaction volume (separately stated for trading occurring during hours when consolidated trade reporting facilities are and are not in operation):

(i) With respect to equity securities, stated in number of trades, number of shares, and total U.S. dollar value;

(ii) With respect to debt securities, stated in total settlement value in U.S. dollars; and

(iii) With respect to other securities, stated in number of trades, number of units of securities, and in dollar value, or other appropriate commonly used measure of value of such securities; and

(C) Time-sequenced records of each transaction effected through the internal broker-dealer system, including date and time executed, price, size, security traded, counterparty identification information, and method of execution (if internal broker-dealer system allows alternative means or locations for execution, such as routing to another market, matching with limit orders, or executing against the quotations of the broker or dealer sponsoring the system).

(ii) For purposes of paragraph (a) of this section, the term:

(A) Internal broker-dealer system shall mean any facility, other than a national securities exchange, an exchange exempt from registration based on limited volume, or an alternative trading system as defined in Regulation ATS, Secs. 242.300 through 242.303 of this chapter, that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating, or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker or dealer sponsor of such system;

(B) Sponsor shall mean any broker or dealer that organizes, operates, administers, or otherwise directly controls an internal broker-dealer trading system or, if the operator of the internal

[[Page 393]]

broker-dealer system is not a registered broker or dealer, any broker or

dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved on a regular basis with executing transactions in connection with use of the internal broker-dealer system, other than solely for its own account or as a customer with access to the internal broker-dealer system; and

(C) System order means any order or other communication or indication submitted by any customer with access to the internal broker-dealer system for entry into a trading system announcing an interest in purchasing or selling a security. The term ``system order'' does not include inquiries or indications of interest that are not entered into the internal broker-dealer system.

(b)(1) This section shall not be deemed to require a member of a national securities exchange, a broker, or dealer who transacts a business in securities through the medium of any such member, or a broker or dealer registered pursuant to section 15 of the Act, to make or keep such records of transactions cleared for such member, broker, or dealer as are customarily made and kept by a clearing broker or dealer pursuant to the requirements of Secs. 240.**17a-3** and 240.**17a**-4: Provided, That the clearing broker or dealer has and maintains net capital of not less than $25,000 and is otherwise in compliance with Sec. 240.15c3-1 or the capital rules of the exchange of which such clearing broker or dealer is a member if the members of such exchange are exempt from Sec. 240.15c3-1 by paragraph (b)(2) thereof.

(2) This section shall not be deemed to require a member of a national securities exchange, a broker, or dealer who transacts a business in securities through the medium of any such member, or a broker or dealer registered pursuant to section 15 of the Act, to make or keep such records of transactions cleared for such member, broker or dealer by a bank as are customarily made and kept by a clearing broker or dealer pursuant to the requirements of Secs. 240.**17a-3** and 240.**17a**-4: Provided, That such member, broker, or dealer obtains from such bank an agreement in writing to the effect that the records made and kept by such bank are the property of the member, broker, or dealer: And provided further, That such bank files with the Commission a written undertaking in form acceptable to the Commission and signed by a duly authorized person, that such books and records are available for examination by representatives of the Commission as specified in section 17(a) of the Act, and that it will furnish to the Commission, upon demand, at its principal office in Washington, DC, or at any regional or district office of the Commission designated in such demand, true, correct, complete, and current copies of any or all of such records. Such undertaking shall include the following provisions:

The undersigned hereby undertakes to maintain and preserve on behalf of [BD] the books and records required to be maintained and preserved by [BD] pursuant to Rules **17a-3** and **17a**-4 under the Securities Exchange Act of 1934 and to permit examination of such books and records at any time or from time to time during business hours by examiners or other representatives of the Securities and Exchange Commission, and to furnish to said Commission at its principal office in Washington, DC, or at any regional or district office of said Commission specified in a demand made by or on behalf of said Commission for copies of books and records, true, correct, complete, and current copies of any or all, or any part, of such books and records. This undertaking shall be binding upon the undersigned, and the successors and assigns of the undersigned.

Nothing herein contained shall be deemed to relieve such member, broker, or dealer from the responsibility that such books and records be accurately maintained and preserved as specified in Secs. 240.**17a-3** and

240.17a-4.

(c) This section shall not be deemed to require a member of a national securities exchange, or a broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934 (48 Stat. 895, 49 Stat. 1377; 15 U.S.C. 78o) as amended, to make or keep such records as are required by paragraph (a) reflecting the sale of United States Tax Savings Notes, United States Defense Savings Stamps, or United States Defense Savings Bonds, Series E, F and G.

(d) The records specified in paragraph (a) of this section shall not be required

[[Page 394]]

with respect to any cash transaction of $100 or less involving only subscription rights or warrants which by their terms expire within 90 days after the issuance thereof.

(e) For purposes of transactions in municipal securities by municipal securities brokers and municipal securities dealers, compliance with Rule G-8 of the Municipal Securities Rulemaking Board will be deemed to be in compliance with this section.

(Secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a))

Cross Reference: For interpretative release applicable to Sec. 240.17a-3, see No. 3040 in tabulation, part 241 of this chapter.

[13 FR 8212, Dec. 22, 1948]

Editorial Note: For Federal Register citations affecting Sec. 240.17a-3, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.

Effective Date Notes: 1. At 66 FR 55838, Nov. 2, 2001, Sec. 240.17a-3 was amended by revising paragraphs (a)(6) and (7), the introductory text of paragraph (a)(12)(i), paragraph (a)(12)(ii), redesignating paragraphs (a)(12)(i)(a) through (a)(12)(i)(h) as paragraphs (a)(12)(i)(A) through (a)(12)(i)(H), adding paragraphs (a)(17), (a)(18), (a)(19), (a)(20), (a)(21), (a)(22), (f) and (g), and by removing the authority citation, effective May 2, 2003. For the convenience of the user, the revised and added text is set forth as follows:

Sec. 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(6)(i) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof; the account for which entered; the time the order was received; the time of entry; the price at which executed; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an

electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. The memorandum need not show the identity of any person, other than the associated person responsible for the account, who may have entered or accepted the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person; in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated. The term instruction shall include instructions between partners and employees of a member, broker or dealer. The term time of entry shall mean the time when the member, broker or dealer transmits the order or instruction for execution.

* * * * *

(ii) This memorandum need not be made as to a purchase, sale or redemption of a security on a subscription way basis directly from or to the issuer, if the member, broker or dealer maintains a copy of the customer's subscription agreement regarding a purchase, or a copy of any other document required by the issuer regarding a sale or redemption.

(7) A memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order and of any modification thereof; the account for which it was entered; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum need not show the identity of any person other than the associated person responsible for the account who may have entered the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person: in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order with a customer other than a member, broker or dealer entered pursuant to the exercise of

[[Page 395]]

discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated.

* * * * *

(12)(i) A questionnaire or application for employment executed by each ``associated person'' (as defined in paragraph (g)(4) of this section) of the member, broker or dealer, which questionnaire or application shall be approved in writing by an authorized representative of the member, broker or dealer and shall contain at least the following information with respect to the associated person:

* * * * *

(ii) A record listing every associated person of the member, broker or dealer which shows, for each associated person, every office of the member, broker or dealer where the associated person regularly conducts the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security for the member, broker or dealer, and the Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the member, broker or dealer.

* * * * *

(17) For each account with a natural person as a customer or owner:

(i)(A) An account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; however, financial information for the individual joint owners may be combined. The account record shall indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the member, broker or dealer. For accounts in existence on the effective date of this section, the member, broker or dealer must obtain this information within three years of the effective date of the section.

(B) A record indicating that:

(1) The member, broker or dealer has furnished to each customer or owner within three years of the effective date of this section, and to each customer or owner who opened an account after the effective date of this section within thirty days of the opening of the account, and thereafter at intervals no greater than thirty-six months, a copy of the account record or an alternate document with all information required by paragraph (a)(17)(i)(A) of this section. The member, broker or dealer may elect to send this notification with the next statement mailed to the customer or owner after the opening of the account. The member, broker or dealer may choose to exclude any tax identification number and date of birth from the account record or alternative document furnished to the customer or owner. The member, broker or dealer shall include with the account record or alternative document provided to each customer or owner an explanation of any terms regarding investment objectives. The account record or alternate document furnished to the customer or owner shall include or be accompanied by prominent statements that the customer or owner should mark any corrections and return the account record or alternate document to the member, broker or dealer, and that the customer or owner should notify the member, broker or dealer of any future changes to information contained in the account record.

(2) For each account record updated to reflect a change in the name or address of the customer or owner, the member, broker or dealer furnished a notification of that change to the customer's old address, or to each joint owner, and the associated person, if any, responsible for that account, on or before the 30th day after the date the member, broker or dealer received notice of the change.

(3) For each change in the account's investment objectives the member, broker or dealer has furnished to each customer or owner, and the associated person, if any, responsible for that account a copy of the updated customer account record or alternative document with all information required to be furnished by paragraph (a)(17)(i)(B)(1) of

this section, on or before the 30th day after the date the member, broker or dealer received notice of any change, or, if the account was updated for some reason other than the firm receiving notice of a change, after the date the account record was updated. The member, broker or dealer may elect to send this notification with the next statement scheduled to be mailed to the customer or owner.

(C) For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record information required under paragraph (a)(17)(i)(A) of this section shall excuse the member, broker or dealer from obtaining that required information.

(D) The account record requirements in paragraph (a)(17)(i)(A) of this section shall only apply to accounts for which the member, broker or dealer is, or has within the past 36 months been, required to make a

[[Page 396]]

suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. Additionally, the furnishing requirement in paragraph (a)(17)(i)(B)(1) of this section shall not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. This paragraph (a)(17)(i)(D) does not relieve a member, broker or dealer from any obligation arising from the rules of a self-regulatory organization of which it is a member regarding the collection of information from a customer or owner.

(ii) If an account is a discretionary account, a record containing the dated signature of each customer or owner granting the authority and the dated signature of each natural person to whom discretionary authority was granted.

(iii) A record for each account indicating that each customer or owner was furnished with a copy of each written agreement entered into on or after the effective date of this paragraph pertaining to that account and that, if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement.

(18) A record:

(i) As to each associated person of each written customer complaint received by the member, broker or dealer concerning that associated person. The record shall include the complainant's name, address, and account number; the date the complaint was received; the name of any other associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. Instead of the record, a member, broker or dealer may maintain a copy of each original complaint in a separate file by the associated person named in the complaint along with a record of the disposition of the complaint.

(ii) Indicating that each customer of the member, broker or dealer has been provided with a notice containing the address and telephone number of the department of the member, broker or dealer to which any complaints as to the account may be directed.

(19) A record:

(i) As to each associated person listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record shall include the amount of compensation if monetary and a description of the compensation if non-monetary. In lieu of making this record, a member, broker or dealer may elect to produce the required information promptly upon request of a representative of a securities regulatory authority.

(ii) Of all agreements pertaining to the relationship between each associated person and the member, broker or dealer including a summary of each associated person's compensation arrangement or plan with the member, broker or dealer, including commission and concession schedules and, to the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation is determined.

(20) A record, which need not be separate from the advertisements, sales literature, or communications, documenting that the member, broker or dealer has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal requirements and rules of a self-regulatory organization of which the member, broker or dealer is a member which require that advertisements, sales literature, or any other communications with the public by a member, broker or dealer or its associated persons be approved by a principal.

(21) A record for each office listing, by name or title, each person at that office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records.

(22) A record listing each principal of a member, broker or dealer responsible for establishing policies and procedures that are reasonably designed to ensure compliance with any applicable federal requirements or rules of a self-regulatory organization of which the member, broker or dealer is a member that require acceptance or approval of a record by a principal.

* * * * *

(f) Every member, broker or dealer shall make and keep current, as to each office, the books and records described in paragraphs (a)(1), (a)(6), (a)(7), (a)(12), (a)(17), (a)(18)(i), (a)(19), (a)(20), (a)(21), and (a)(22) of this section.

(g) When used in this section:

(1) The term office means any location where one or more associated persons regularly conduct the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security.

(2) The term principal means any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer or any other person who has been delegated supervisory responsibility over associated persons by the member, broker or dealer.

(3) The term securities regulatory authority means the Commission, any self-regulatory organization, or any securities commission (or any agency or office performing like functions) of the States.

[[Page 397]]

(4) The term associated person means an ``associated person of a member'' or ``associated person of a broker or dealer'' as defined in sections 3(a)(21) and 3(a)(18) of the Act (15 U.S.C. 78c(a)(21) and (a)(18)) respectively, but shall not include persons whose functions are solely clerical or ministerial.

2. At 66 FR 55840, Nov. 2, 2001, Sec. 240.17a-3 was amended by removing from the introductory text of paragraph (a) and paragraph (a)(5) the word ``his'' and in its place adding ``it'', removing from paragraph (a)(11)(ii) the word ``he'' and in its place adding ``it'', removing from redesignated paragraphs (a)(12)(i)(A) and (a)(12)(i)(B) the word ``His'' and in its place adding ``The associated person's'',

removing from redesignated paragraphs (a)(12)(i)(A), (a)(12)(i)(C), and (a)(12)(i)(H) the word ``his'' and in its place adding ``the associated person's'', removing from redesignated paragraphs (a)(12)(i)(D) and (a)(12)(i)(F) the word ``him'' and in its place adding ``the associated person'', removing from redesignated paragraphs (a)(12)(i)(D), (a)(12)(i)(E), (a)(12)(i)(F) and (a)(12)(i)(H) the word ``he'' and in its place adding ``the associated person'' and removing from redesignated paragraph (a)(12)(i)(H) the phrase ``or the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Coast Stock Exchange, or the Philadelphia-Baltimore Stock Exchange'' and in its place adding ``the American Stock Exchange LLC, the Boston Stock Exchange, Inc., the Chicago Stock Exchange, Inc., the New York Stock Exchange, Inc., the Pacific Exchange, Inc., the Philadelphia Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the Cincinnati Stock Exchange, Inc. or the International Securities Exchange'', effective May 2, 2003.

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[CITE: 17CFR240.17a-4]

[Page 397-403]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.17a-4 Records to be preserved by certain exchange members, brokers and dea

(a) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve for a period of not less than 6 years, the first 2 years in an easily accessible place, all records required to be made pursuant to Sec. 240.17a-3(a) (1), (2), (3), and (5).

(b) Every such broker and dealer shall preserve for a period of not less than 3 years, the first two years in an accessible place:

(1) All records required to be made pursuant to paragraphs (a)(4), (a)(6), (a)(7), (a)(8), (a)(9), (a)(10), and (a)(16) of Sec. 240.17a-3.

(2) All check books, bank statements, cancelled checks and cash reconciliations.

(3) All bills receivable or payable (or copies thereof), paid or unpaid, relating to the business of such member, broker or dealer, as such.

(4) Originals of all communications received and copies of all communications sent by such member, broker or dealer (including inter-office memoranda and communications) relating to his business as such.

(5) All trial balances, computations of aggregate indebtedness and net capital (and working papers in connection therewith), financial statements, branch office reconciliations, and internal audit working papers, relating to the business of such member, broker or dealer, as such.

(6) All guarantees of accounts and all powers of attorney and other evidence of the granting of any discretionary authority given in respect of any account, and copies of resolutions empowering an agent to act on behalf of a corporation.

(7) All written agreements (or copies thereof) entered into by such member, broker or dealer relating to his business as such, including agreements with respect to any account.

(8) Records which contain the following information in support of amounts included in the report prepared as of the audit date on Form X-17A-5 (Sec. 249.617 of this chapter) Part II or Part IIA or Part IIB and in annual audited financial statements required by Sec. 240.17a-5(d) and Sec. 240.17a-12(b):

(i) Money balance position, long or short, including description, quantity, price and valuation of each security including contractual commitments in customers' accounts, in cash and fully secured accounts, partly secured accounts, unsecured accounts, and in securities accounts payable to customers;

(ii) Money balance and position, long or short, including description, quantity, price and valuation of each security including contractual commitments in non-customers' accounts, in cash and fully

secured accounts, partly secured and unsecured accounts, and in securities accounts payable to non-customers;

[[Page 398]]

(iii) Position, long or short, including description, quantity, price and valuation of each security including contractual commitments included in the Computation of Net Capital as commitments, securities owned, securities owned not readily marketable, and other investments owned not readily marketable;

(iv) Amount of secured demand note, description of collateral securing such secured demand note including quantity, price and valuation of each security and cash balance securing such secured demand note;

(v) Description of futures commodity contracts, contract value on trade date, market value, gain or loss, and liquidating equity or deficit in customers' and non-customers' accounts;

(vi) Description of futures commodity contracts, contract value on trade date, market value, gain or loss and liquidating equity or deficit in trading and investment accounts;

(vii) Description, money balance, quantity, price and valuation of each spot commodity position or commitments in customers' and non-customers' accounts;

(viii) Description, money balance, quantity, price and valuation of each spot commodity position or commitments in trading and investment accounts;

(ix) Number of shares, description of security, exercise price, cost and market value of put and call options including short out of the money options having no market or exercise value, showing listed and unlisted put and call options separately;

(x) Quantity, price, and valuation of each security underlying the haircut for undue concentration made in the Computation for Net Capital;

(xi) Description, quantity, price and valuation of each security and commodity position or contractual commitment, long or short, in each joint account in which the broker or dealer has an interest, including each participant's interest and margin deposit;

(xii) Description, settlement date, contract amount, quantity, market price, and valuation for each aged failed to deliver requiring a charge in the Computation of Net Capital pursuant to Sec. 240.15c3-1;

(xiii) Detail relating to information for possession or control requirements under Sec. 240.15c3-3 and reported on the schedule in Part II or IIA of Form X-**17A**-5 (Sec. 249.617 of this chapter);

(xiv) Detail of all items, not otherwise substantiated, which are charged or credited in the Computation of Net Capital pursuant to Sec. 240.15c3-1, such as cash margin deficiencies, deductions related to securities values and undue concentration, aged securities differences and insurance claims receivable; and

(xv) Other schedules which are specifically prescribed by the Commission as necessary to support information reported as required by Sec. 240.**17a**-5 and Sec. 240.**17a**-12.

(9) The records required to be made pursuant to Sec. 240.15c3-3(d)(**4**).

(10) The records required to be made pursuant to Sec. 240.15c3-**4** and the results of the periodic reviews conducted pursuant to Sec. 240.15c3-**4**(d).

(11) All notices relating to an internal broker-dealer system provided to the customers of the broker or dealer that sponsors such internal broker-dealer system, as defined in paragraph (a)(16)(ii)(A) of Sec. 240.**17a**-3. Notices, whether written or communicated through the internal broker-dealer trading system or other automated means, shall be

preserved under this paragraph (b)(11) if they are provided to all customers with access to an internal broker-dealer system, or to one or more classes of customers. Examples of notices to be preserved under this paragraph (b)(11) include, but are not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, and instructions pertaining to access to the internal broker-dealer system.

(c) Every such member, broker and dealer shall preserve for a period of not less than 6 years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of such account.

(d) Every such member, broker and dealer shall preserve during the life of the enterprise and of any successor enterprise all partnership articles or, in

[[Page 399]]

the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books.

(e) Every such member, broker and dealer shall maintain and preserve in an easily accessible place:

(1) All records required under paragraph (a)(12) of Sec. 240.**17a**-3 until at least three years after the ``associated person'' has terminated his employment and any other connection with the member, broker or dealer.

(2) All records required under paragraph (a)(13) of Sec. 240.**17a**-3 until at least three years after the termination of employment or association of those persons required by Sec. 240.17f-2 to be fingerprinted; and

(3) All records required pursuant to paragraph (a)(15) of Sec. 240.**17a**-3 for the life of the enterprise.

(**4**) All records required pursuant to paragraph (a)(14) of Sec. 240.**17a**-3 for three years.

(f) The records required to be maintained and preserved pursuant to Secs. 240.**17a**-3 and 240.**17a-4** may be immediately produced or reproduced on ``micrographic media'' (as defined in this section) or by means of ``electronic storage media'' (as defined in this section) that meet the conditions set forth in this paragraph and be maintained and preserved for the required time in that form..

(1) For purposes of this section:

(i) The term micrographic media means microfilm or microfiche, or any similar medium; and

(ii) The term electronic storage media means any digital storage medium or system and, in the case of both paragraphs (f)(1)(i) and (f)(1)(ii) of this section, that meets the applicable conditions set forth in this paragraph (f).

(2) If electronic storage media is used by a member, broker, or dealer, it shall comply with the following requirements:

(i) The member, broker, or dealer must notify its examining authority designated pursuant to section 17(d) of the Act (15 U.S.C. 78q(d)) prior to employing electronic storage media. If employing any electronic storage media other than optical disk technology (including CD-ROM), the member, broker, or dealer must notify its designated examining authority at least 90 days prior to employing such storage media. In either case, the member, broker, or dealer must provide its own representation or one from the storage medium vendor or other third party with appropriate expertise that the selected storage media meets the conditions set forth in this paragraph (f)(2).

(ii) The electronic storage media must:

(A) Preserve the records exclusively in a non-rewriteable, non-

erasable format;

(B) Verify automatically the quality and accuracy of the storage media recording process;

(C) Serialize the original and, if applicable, duplicate units of storage media, and time-date for the required period of retention the information placed on such electronic storage media; and

(D) Have the capacity to readily download indexes and records preserved on the electronic storage media to any medium acceptable under this paragraph (f) as required by the Commission or the self-regulatory organizations of which the member, broker, or dealer is a member.

(3) If a member, broker, or dealer uses micrographic media or electronic storage media, it shall:

(i) At all times have available, for examination by the staffs of the Commission and self-regulatory organizations of which it is a member, facilities for immediate, easily readable projection or production of micrographic media or electronic storage media images and for producing easily readable images.

(ii) Be ready at all times to provide, and immediately provide, any facsimile enlargement which the Commission or its representatives may request.

(iii) Store separately from the original, a duplicate copy of the record stored on any medium acceptable under Sec. 240.**17a-4** for the time required.

(iv) Organize and index accurately all information maintained on both original and any duplicate storage media.

(A) At all times, a member, broker, or dealer must be able to have such indexes available for examination by the staffs of the Commission and the self- regulatory organizations of which the broker or dealer is a member.

[[Page 400]]

(B) Each index must be duplicated and the duplicate copies must be stored separately from the original copy of each index.

(C) Original and duplicate indexes must be preserved for the time required for the indexed records.

(v) The member, broker, or dealer must have in place an audit system providing for accountability regarding inputting of records required to be maintained and preserved pursuant to Secs. 240.**17a**-3 and 240.**17a-4** to electronic storage media and inputting of any changes made to every original and duplicate record maintained and preserved thereby.

(A) At all times, a member, broker, or dealer must be able to have the results of such audit system available for examination by the staffs of the Commission and the self-regulatory organizations of which the broker or dealer is a member.

(B) The audit results must be preserved for the time required for the audited records.

(vi) The member, broker, or dealer must maintain, keep current, and provide promptly upon request by the staffs of the Commission or the self-regulatory organizations of which the member, broker, or broker-dealer is a member all information necessary to access records and indexes stored on the electronic storage media; or place in escrow and keep current a copy of the physical and logical file format of the electronic storage media, the field format of all different information types written on the electronic storage media and the source code, together with the appropriate documentation and information necessary to access records and indexes.

(vii) For every member, broker, or dealer exclusively using electronic storage media for some or all of its record preservation under this section, at least one third party (``the undersigned''), who

has access to and the ability to download information from the member's, broker's, or dealer's electronic storage media to any acceptable medium under this section, shall file with the designated examining authority for the member, broker, or dealer the following undertakings with respect to such records:

The undersigned hereby undertakes to furnish promptly to the U.S. Securities and Exchange Commission (``Commission''), its designees or representatives, upon reasonable request, such information as is deemed necessary by the Commission's or designee's staff to download information kept on the broker's or dealer's electronic storage media to any medium acceptable under Rule **17a-4**.

Furthermore, the undersigned hereby undertakes to take reasonable steps to provide access to information contained on the broker's or dealer's electronic storage media, including, as appropriate, arrangements for the downloading of any record required to be maintained and preserved by the broker or dealer pursuant to Rules **17a**-3 and **17a-4** under the Securities Exchange Act of 1934 in a format acceptable to the Commission's staff or its designee. Such arrangements will provide specifically that in the event of a failure on the part of a broker or dealer to download the record into a readable format and after reasonable notice to the broker or dealer, upon being provided with the appropriate electronic storage medium, the undersigned will undertake to do so, as the Commission's staff or its designee may request.

(g) If a person who has been subject to Sec. 240.**17a**-3 ceases to transact a business in securities directly with others than members of a national securities exchange, or ceases to transact a business in securities through the medium of a member of a national securities exchange, or ceases to be registered pursuant to section 15 of the Securities Exchange Act of 1934 as amended (48 Stat. 895, 49 Stat. 1377; 15 U.S.C. 78o), such person shall, for the remainder of the periods of time specified in this section, continue to preserve the records which he theretofore preserved pursuant to this section.

(h) For purposes of transactions in municipal securities by municipal securities brokers and municipal securities dealers, compliance with Rule G-9 of the Municipal Securities Rulemaking Board will be deemed to be in compliance with this section.

(i) If the records required to be maintained and preserved pursuant to the provisions of Secs. 240.**17a**-3 and 240.**17a-4** are prepared or maintained by an outside service bureau, depository, bank which does not operate pursuant to Sec. 240.**17a**-3(b)(2), or other recordkeeping service on behalf of the member, broker or dealer required to maintain and preserve such records, such outside entity shall file with the Commission a

[[Page 401]]

written undertaking in form acceptable to the Commission, signed by a duly authorized person, to the effect that such records are the property of the member, broker or dealer required to maintain and preserve such records and will be surrendered promptly on request of the member, broker or dealer and including the following provision:

With respect to any books and records maintained or preserved on behalf of [BD], the undersigned hereby undertakes to permit examination of such books and records at any time or from time to time during business hours by representatives or designees of the Securities and Exchange Commission, and to promptly furnish to said Commission or its designee true, correct, complete and current hard copy of any or all or

any part of such books and records.

Agreement with an outside entity shall not relieve such member, broker or dealer from the responsibility to prepare and maintain records as specified in this section or in Sec. 240.**17a**-3.

(j) Every member, broker or dealer subject to this section shall furnish promptly to a representative of the Commission such legible, true and complete copies of those records of the member, broker or dealer, which are required to be preserved under this section, as are requested by the representative of the Commission.

(Secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78a; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a; sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w))

Cross Reference: For interpretative releases applicable to Sec. 240.**17a-4**, see No. 3040 and No. 8024 in tabulation, part 241 of this chapter.

[13 FR 8212, Dec. 22, 1948]

Editorial Note: For Federal Register citations affecting Sec. 240.**17a-4**, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.

Effective Date Notes: 1. At 66 FR 55838, Nov. 2, 2001, Sec. 240.**17a-4** was amended by removing its authority citation effective May 2, 2003.

2. At 66 FR 55840, Nov. 2, 2001, Sec. 240.**17a-4** was amended by revising paragraph (a), the introductory text of paragraph (b), paragraphs (b)(1), (b)(**4**), (c) and (d), the introductory text of paragraph (e) and paragraph (j), and adding paragraphs (e)(5) through (8) and paragraphs (k) and (l), effective May 2, 2003. For the convenience of the user, the added and revised text is set forth as follows:

Sec. 240.**17a-4** Records to be preserved by certain exchange members, brokers and dealers.

(a) Every member, broker and dealer subject to Sec. 240.**17a**-3 shall preserve for a period of not less than six years, the first two years in an easily accessible place, all records required to be made pursuant to paragraphs Sec. 240.**17a**-3(a)(1), (a)(2), (a)(3), (a)(5), (a)(21), (a)(22), and analogous records created pursuant to paragraph Sec. 240.**17a**-3(f).

(b) Every member, broker and dealer subject to Sec. 240.**17a**-3 shall preserve for a period of not less than three years, the first two years in an easily accessible place:

(1) All records required to be made pursuant to Sec. 240.**17a**-3(a)(**4**), (a)(6), (a)(7), (a)(8), (a)(9), (a)(10), (a)(16), (a)(18), (a)(19), (a)(20), and analogous records created pursuant to Sec. 240.**17a**-3(f).

* * * * *

(**4**) Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to

rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public. As used in this paragraph (b)(4), the term communications includes sales scripts.

* * * * *

(c) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve for a period of not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account.

(d) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve during the life of the enterprise and of any successor enterprise all partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books (or, in the case of any other form of legal entity, all records such as articles of organization or formation, and minute books used for a purpose similar to those records required for corporations or partnerships), all Forms BD (Sec. 249.501 of this chapter), all Forms BDW (Sec. 249.501a of this chapter), all amendments to these forms, all licenses or other documentation showing the registration of the member, broker or dealer with any securities regulatory authority.

[[Page 402]]

(e) Every member, broker and dealer subject to Sec. 240.17a-3 shall maintain and preserve in an easily accessible place:

* * * * *

(5) All account record information required pursuant to Sec. 240.17a-3(a)(17) until at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

(6) Each report which a securities regulatory authority has requested or required the member, broker or dealer to make and furnish to it pursuant to an order or settlement, and each securities regulatory authority examination report until three years after the date of the report.

(7) Each compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual, describing the policies and practices of the member, broker or dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the member, broker or dealer until three years after the termination of the use of the manual.

(8) All reports produced to review for unusual activity in customer accounts until eighteen months after the date the report was generated. In lieu of maintaining the reports, a member, broker or dealer may produce promptly the reports upon request by a representative of a securities regulatory authority. If a report was generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced using historical data in the same format as it was originally generated, the report may be produced by using the historical data in the current system, but must be accompanied by a record explaining each system change which affected the reports. If a report is generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced in any format using historical data, the member, broker or dealer shall promptly produce upon request a record of

the parameters that were used to generate the report at the time specified by a representative of a securities regulatory authority, including a record of the frequency with which the reports were generated.

* * * * *

(j) Every member, broker and dealer subject to this section shall furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records of the member, broker or dealer that are required to be preserved under this section, or any other records of the member, broker or dealer subject to examination under section 17(b) of the Act (15 U.S.C. 78q(b)) that are requested by the representative of the Commission.

(k) Records for the most recent two year period required to be made pursuant to Sec. 240.**17a**-3(f) and paragraphs (b)(**4**) and (e)(7) of this section which relate to an office shall be maintained at the office to which they relate. If an office is a private residence where only one associated person (or multiple associated persons who reside at that location and are members of the same immediate family) regularly conducts business, and it is not held out to the public as an office nor are funds or securities of any customer of the member, broker or dealer handled there, the member, broker or dealer need not maintain records at that office, but the records must be maintained at another location within the same State as the member, broker or dealer may select. Rather than maintain the records at each office, the member, broker or dealer may choose to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative.

(l) When used in this section:

(1) The term office shall have the meaning set forth in Sec. 240.**17a**-3(g)(1).

(2) The term principal shall have the meaning set forth in Sec. 240.**17a**-3(g)(2).

(3) The term securities regulatory authority shall have the meaning set forth in Sec. 240.**17a**-3(g)(3).

(**4**) The term associated person shall have the meaning set forth in Sec. 240.**17a**-3(g)(**4**).

3. At 66 FR 55841, Nov. 2, 2001, Sec. 240.**17a-4** was amended by removing from paragraph (b)(7) the word ``his'' and in its place adding ``its'', removing from paragraph (e)(1) the phrase ``the ``associated person'' has terminated his employment and any other connection with the member, broker or dealer.'' and in its place adding ``the associated person's employment and any other connection with the member, broker or dealer has terminated.'', removing from paragraph (f)(3)(ii) the phrase ``the Commission or its representatives'' and in its place adding ``the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer'', removing from paragraph (f)(3)(vii), the phrase ``the U.S. Securities and Exchange Commission (``Commission''), its designees or representatives,'' and in its place adding ``the U.S. Securities and Exchange Commission (``Commission''), its designees or representatives, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer,'', the phrase ``the Commission's or designee's staff'' and in its place adding ``the staffs of the Commission, any

[[Page 403]]

self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer'', and from each place it appears, the phrase ``the Commission's staff or its designee'' and in its place adding ``the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer'', effective May 2, 2003.

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[CITE: 17CFR240.15g-1]

[Page 357]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.15g-1 Exemptions for certain transactions.

The following transactions shall be exempt from 17 CFR 240.15g-2, 17 CFR 240.15g-3, 17 CFR 240.15g-4, 17 CFR 240.15g-5, and 17 CFR 240.15g-6:

(a) Transactions by a broker or dealer:

(1) Whose commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny stocks during each of the immediately preceding three months and during eleven or more of the preceding twelve months, or during the immediately preceding six months, did not exceed five percent of its total commissions, commission equivalents, mark-ups, and mark-downs from transactions in securities during those months; and

(2) Who has not been a market maker in the penny stock that is the subject of the transaction in the immediately preceding twelve months.

Note: Prior to April 28, 1993, commissions, commission equivalents, mark-ups, and mark-downs from transactions in designated securities, as defined in 17 CFR 240.15c2-6(d)(2) as of April 15, 1992, may be considered to be commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny stocks for purposes of paragraph (a)(1) of this section.

(b) Transactions in which the customer is an institutional accredited investor, as defined in 17 CFR 230.501(a) (1), (2), (3), (7), or (8).

(c) Transactions that meet the requirements of Regulation D (17 CFR 230.501-230.508), or transactions with an issuer not involving any public offering pursuant to section 4(2) of the Securities Act of 1933.

(d) Transactions in which the customer is the issuer, or a director, officer, general partner, or direct or indirect beneficial owner of more than five percent of any class of equity security of the issuer, of the penny stock that is the subject of the transaction.

(e) Transactions that are not recommended by the broker or dealer.

(f) Any other transaction or class of transactions or persons or class of persons that, upon prior written request or upon its own motion, the Commission conditionally or unconditionally exempts by order as consistent with the public interest and the protection of investors.

[57 FR 18032, Apr. 28, 1992]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[**CITE: 17CFR240.15g-2**]

[Page 357]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-2** Risk disclosure document relating to the penny stock market.

(a) It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule **15G**, 17 CFR 240.**15g**-100, and has obtained from the customer a manually signed and dated written acknowledgement of receipt of the document.

(b) The broker or dealer shall preserve, as part of its records, a copy of the written acknowledgment required by paragraph (a) of this section for the period specified in 17 CFR 240.17a-4(b) of this chapter.

[58 FR 37417, July 12, 1993]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[CITE: 17CFR240.15g-3]

[Page 357-359]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.15g-3 Broker or dealer disclosure of quotations and other information rela

(a) Requirement. It shall be unlawful for a broker or dealer to effect a transaction in any penny stock with or for the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b)

[[Page 358]]

of this section, the following information:

(1) The inside bid quotation and the inside offer quotation for the penny stock.

(2) If paragraph (a)(1) of this section does not apply because of the absence of an inside bid quotation and an inside offer quotation:

(i) With respect to a transaction effected with or for a customer on a principal basis (other than as provided in paragraph (a)(2)(ii) of this section):

(A) The dealer shall disclose its offer price for the security:

(1) If during the previous five days the dealer has effected no fewer than three bona fide sales to other dealers consistently at its offer price for the security current at the time of those sales, and

(2) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its offer price accurately reflects the price at which it is willing to sell one or more round lots to another dealer. For purposes of paragraph (a)(2)(i)(A) of this section, ``consistently'' shall constitute, at a minimum, seventy-five percent of the dealer's bona fide interdealer sales during the previous five-day period, and, if the dealer has effected only three bona fide inter-dealer sales during such period, all three of such sales.

(B) The dealer shall disclose its bid price for the security:

(1) If during the previous five days the dealer has effected no fewer than three bona fide purchases from other dealers consistently at its bid price for the security current at the time of those purchases, and

(2) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its bid price accurately reflects the price at which it is willing to buy one or more round lots from another dealer. For purposes of paragraph (a)(2)(i)(B) of this section, ``consistently'' shall constitute, at a minimum, seventy-five percent of the dealer's bona fide interdealer purchases during the previous five-day period, and, if the dealer has effected only three bona fide inter-dealer purchases during such period, all three of such purchases.

(C) If the dealer's bid or offer prices to the customer do not

satisfy the criteria of paragraphs (a)(2)(i)(A) or (a)(2)(i)(B) of this section, the dealer shall disclose to the customer:

(1) That it has not effected inter-dealer purchases or sales of the penny stock consistently at its bid or offer price, and

(2) The price at which it last purchased the penny stock from, or sold the penny stock to, respectively, another dealer in a bona fide transaction.

(ii) With respect to transactions effected by a broker or dealer with or for the account of the customer:

(A) On an agency basis or

(B) On a basis other than as a market maker in the security, where, after having received an order from the customer to purchase a penny stock, the dealer effects the purchase from another person to offset a contemporaneous sale of the penny stock to such customer, or, after having received an order from the customer to sell the penny stock, the dealer effects the sale to another person to offset a contemporaneous purchase from such customer, the broker or dealer shall disclose the best independent interdealer bid and offer prices for the penny stock that the broker or dealer obtains through reasonable diligence. A broker-dealer shall be deemed to have exercised reasonable diligence if it obtains quotations from three market makers in the security (or all known market makers if there are fewer than three).

(3) With respect to bid or offer prices and transaction prices disclosed pursuant to paragraph (a) of this section, the broker or dealer shall disclose the number of shares to which the bid and offer prices apply.

(b) Timing. (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b-10 of this chapter.

[[Page 359]]

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a-4(b).

(c) Definitions. For purposes of this section:

(1) The term bid price shall mean the price most recently communicated by the dealer to another broker or dealer at which the dealer is willing to purchase one or more round lots of the penny stock, and shall not include indications of interest.

(2) The term offer price shall mean the price most recently communicated by the dealer to another broker or dealer at which the dealer is willing to sell one or more round lots of the penny stock, and shall not include indications of interest.

(3) The term inside bid quotation for a security shall mean the highest bid quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(4) The term inside offer quotation for a security shall mean the lowest offer quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on

such system bid and offer quotations for the security at specified prices.

(5) The term Qualifying Electronic Quotation System shall mean an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such other automated interdealer quotation system designated by the Commission for purposes of this section.

[57 FR 18033, Apr. 28, 1992]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[**CITE: 17CFR240.15g-4**]

[Page 359-360]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-4** Disclosure of compensation to brokers or dealers.

Preliminary Note: Brokers and dealers may wish to refer to Securities Exchange Act Release No. 30608 (April 20, 1992) for a discussion of the procedures for computing compensation in active and competitive markets, inactive and competitive markets, and dominated and controlled markets.

(a) Disclosure requirement. It shall be unlawful for any broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the aggregate amount of any compensation received by such broker or dealer in connection with such transaction.

(b) Timing. (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b-10.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a-**4**(b).

(c) Definition of compensation. For purposes of this section, compensation means, with respect to a transaction in a penny stock:

(1) If a broker is acting as agent for a customer, the amount of any remuneration received or to be received by it from such customer in connection with such transaction;

(2) If, after having received a buy order from a customer, a dealer other than a market maker purchased the penny stock as principal from another person to offset a contemporaneous sale to such customer or, after having received a sell order from a customer, sold the penny stock as principal to another person to offset a contemporaneous purchase from such customer, the difference between the price to the customer and such contemporaneous purchase or sale price; or

[[Page 360]]

(3) If the dealer otherwise is acting as principal for its own account, the difference between the price to the customer and the

prevailing market price.

(d) Active and competitive market. For purposes of this section only, a market may be deemed to be ``active and competitive'' in determining the prevailing market price with respect to a transaction by a market maker in a penny stock if the aggregate number of transactions effected by such market maker in the penny stock in the five business days preceding such transaction is less than twenty percent of the aggregate number of all transactions in the penny stock reported on a Qualifying Electronic Quotation System (as defined in 17 CFR 240.**15g**-3(c)(5)) during such five-day period. No presumption shall arise that a market is not ``active and competitive'' solely by reason of a market maker not meeting the conditions specified in this paragraph.

[57 FR 18034, Apr. 28, 1992]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[**CITE: 17CFR240.15g-5**]

[Page 360]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-5** Disclosure of compensation of associated persons in connection with penny stock transactions.

(a) General. It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless the broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the aggregate amount of cash compensation that any associated person of the broker or dealer who is a natural person and has communicated with the customer concerning the transaction at or prior to receipt of the customer's transaction order, other than any person whose function is solely clerical or ministerial, has received or will receive from any source in connection with the transaction and that is determined at or prior to the time of the transaction, including separate disclosure, if applicable, of the source and amount of such compensation that is not paid by the broker or dealer.

(b) Timing. (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b-10.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a-4(b).

(c) Contingent compensation arrangements. Where a portion or all of the cash or other compensation that the associated person may receive in connection with the transaction may be determined and paid following the transaction based on aggregate sales volume levels or other contingencies, the written disclosure required by paragraph (b)(1)(ii) of this section shall state that fact and describe the basis upon which such compensation is determined.

[57 FR 18034, Apr. 28, 1992]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[**CITE: 17CFR240.15g-6**]

[Page 360-362]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-6** Account statements for penny stock customers.

(a) Requirement. It shall be unlawful for any broker or dealer that has effected the sale to any customer, other than in a transaction that is exempt pursuant to 17 CFR 240.**15g-**1, of any security that is a penny stock on the last trading day of any calendar month, or any successor of such broker or dealer, to fail to give or send to such customer a written statement containing the information described in paragraphs (c) and (d) of this section with respect to each such month in which such security is held for the customer's account with the broker or dealer, within ten days following the end of such month.

(b) Exemptions. A broker or dealer shall be exempted from the requirement of paragraph (a) of this section under either of the following circumstances:

(1) If the broker or dealer does not effect any transactions in penny stocks for or with the account of the customer during a period of six consecutive calendar months, then the broker or dealer shall not be required to provide monthly statements for each quarterly period that is immediately subsequent

[[Page 361]]

to such six-month period and in which the broker or dealer does not effect any transaction in penny stocks for or with the account of the customer, provided that the broker or dealer gives or sends to the customer written statements containing the information described in paragraphs (d) and (e) of this section on a quarterly basis, within ten days following the end of each such quarterly period.

(2) If, on all but five or fewer trading days of any quarterly period, a security has a price of five dollars or more, the broker or dealer shall not be required to provide a monthly statement covering the security for subsequent quarterly periods, until the end of any such subsequent quarterly period on the last trading day of which the price of the security is less than five dollars.

(c) Price determinations. For purposes of paragraphs (a) and (b) of this section, the price of a security on any trading day shall be determined at the close of business in accordance with the provisions of 17 CFR 240.3a51-1(d)(1).

(d) Market and price information. The statement required by paragraph (a) of this section shall contain at least the following information with respect to each penny stock covered by paragraph (a) of this section, as of the last trading day of the period to which the statement relates:

(1) The identity and number of shares or units of each such security held for the customer's account; and

(2) The estimated market value of the security, to the extent that such estimated market value can be determined in accordance with the following provisions:

(i) The highest inside bid quotation for the security on the last trading day of the period to which the statement relates, multiplied by the number of shares or units of the security held for the customer's account; or

(ii) If paragraph (d)(2)(i) of this section is not applicable because of the absence of an inside bid quotation, and if the broker or dealer furnishing the statement has effected at least ten separate Qualifying Purchases in the security during the last five trading days of the period to which the statement relates, the weighted average price per share paid by the broker or dealer in all Qualifying Purchases effected during such five-day period, multiplied by the number of shares or units of the security held for the customer's account; or

(iii) If neither of paragraphs (d)(2)(i) nor (d)(2)(ii) of this section is applicable, a statement that there is ``no estimated market value'' with respect to the security.

(e) Legend. In addition to the information required by paragraph (d) of this section, the written statement required by paragraph (a) of this section shall include a conspicuous legend that is identified with the penny stocks described in the statement and that contains the following language:

If this statement contains an estimated value, you should be aware that this value may be based on a limited number of trades or quotes. Therefore, you may not be able to sell these securities at a price equal or near to the value shown. However, the broker-dealer furnishing this statement may not refuse to accept your order to sell these securities. Also, the amount you receive from a sale generally will be reduced by the amount of any commissions or similar charges. If an estimated value is not shown for a security, a value could not be determined because of a lack of information.

(f) Preservation of records. Any broker or dealer subject to this section shall preserve, as part of its records, copies of the written statements required by paragraph (a) of this section and keep such records for the periods specified in 17 CFR 240.17a-4(b).

(g) Definitions. For purposes of this section:

(1) The term Quarterly period shall mean any period of three consecutive full calendar months.

(2) The inside bid quotation for a security shall mean the highest bid quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(3) The term Qualifying Electronic Quotation System shall mean an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such

[[Page 362]]

other automated interdealer quotation system designated by the Commission for purposes of this section.

(4) The term Qualifying Purchases shall mean bona fide purchases by a broker or dealer of a penny stock for its own account, each of which involves at least 100 shares, but excluding any block purchase involving

more than one percent of the outstanding shares or units of the security.

[57 FR 18034, Apr. 28, 1992]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[CITE: 17CFR240.15g-8]

[Page 362]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-8** Sales of escrowed securities of blank check companies.

As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any person to sell or offer to sell any security that is deposited and held in an escrow or trust account pursuant to Rule 419 under the Securities Act of 1933 (17 CFR 230.419), or any interest in or related to such security, other than pursuant to a qualified domestic relations order as defined by the Internal Revenue Code of 1986, as amended (26 U.S.C. 1 et seq.), or Title I of the Employee Retirement Income Security Act (29 U.S.C. 1001 et seq.), or the rules thereunder.

[57 FR 18045, Apr. 28, 1992]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[**CITE: 17CFR240.15g-9**]

[Page 362-363]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-9** Sales practice requirements for certain low-priced securities.

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for a broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, any person unless:

(1) The transaction is exempt under paragraph (c) of this section; or

(2) Prior to the transaction:

(i) The broker or dealer has approved the person's account for transactions in penny stocks in accordance with the procedures set forth in paragraph (b) of this section; and

(ii) The broker or dealer has received from the person a written agreement to the transaction setting forth the identity and quantity of the penny stock to be purchased.

(b) In order to approve a person's account for transactions in penny stocks, the broker or dealer must:

(1) Obtain from the person information concerning the person's financial situation, investment experience, and investment objectives;

(2) Reasonably determine, based on the information required by paragraph (b)(1) of this section and any other information known by the broker-dealer, that transactions in penny stocks are suitable for the person, and that the person (or the person's independent adviser in these transactions) has sufficient knowledge and experience in financial matters that the person (or the person's independent adviser in these transactions) reasonably may be expected to be capable of evaluating the risks of transactions in penny stocks;

(3) Deliver to the person a written statement:

(i) Setting forth the basis on which the broker or dealer made the determination required by paragraph (b)(2) of this section;

(ii) Stating in a highlighted format that it is unlawful for the broker or dealer to effect a transaction in a penny stock subject to the provisions of paragraph (a)(2) of this section unless the broker or dealer has received, prior to the transaction, a written agreement to the transaction from the person; and

(iii) Stating in a highlighted format immediately preceding the customer signature line that:

(A) The broker or dealer is required by this section to provide the person with the written statement; and

(B) The person should not sign and return the written statement to the broker or dealer if it does not accurately reflect the person's financial situation, investment experience, and investment objectives; and

(4) Obtain from the person a manually signed and dated copy of the written statement required by paragraph (b)(3) of this section.

(c) For purposes of this section, the following transactions shall be exempt:

(1) Transactions that are exempt under 17 CFR 240.**15g**-1 (a), (b), (d), (e), and (f).

(2) Transactions that meet the requirements of 17 CFR 230.505 or 230.506

[[Page 363]]

(including, where applicable, the requirements of 17 CFR 230.501 through 230.503, and 17 CFR 230.507 through 230.508), or transactions with an issuer not involving any public offering pursuant to section 4(2) of the Securities Act of 1933.

(3) Transactions in which the purchaser is an established customer of the broker or dealer.

(d) For purposes of this section:

(1) The term penny stock shall have the same meaning as in 17 CFR 240.3a51-1.

(2) The term established customer shall mean any person for whom the broker or dealer, or a clearing broker on behalf of such broker or dealer, carries an account, and who in such account:

(i) Has effected a securities transaction, or made a deposit of funds or securities, more than one year previously; or

(ii) Has made three purchases of penny stocks that occurred on separate days and involved different issuers.

[54 FR 35481, Aug. 28, 1989. Redesignated and amended at 58 FR 37417, July 12, 1993]

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[**CITE: 17CFR240.15g-100**]

[Page 363-366]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15g-100** Schedule **15G**--Information to be included in the document distribut

Securities and Exchange Commission

Washington, DC 20549

Schedule **15G**

Under the Securities Exchange Act of 1934

Instructions to Schedule **15G**

A. The information contained in Schedule **15G** (``Schedule'') must be reproduced in its entirety. No language of the document may be omitted, added to, or altered in any way. No material may be given to a customer that is intended in any way to detract from, rebut, or contradict the Schedule.

B. The document entitled ``Important Information on Penny Stocks'' must be distributed as the first page of Schedule **15G**, and on one page only. The remainder of Schedule **15G**, entitled ``Further Information,'' explains the items discussed in the first page in greater detail.

C. The disclosures made through the Schedule are in addition to any other disclosure(s) that are required to be made under the federal securities laws, including without limitation the disclosures required pursuant to the rules adopted under Sections 15(c)(1), 15(c)(2), and 15(g) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(c) (1) and (2), and 15 U.S.C. 78o(g), respectively.

D. The format and typeface of the document must be reproduced as presented in the Schedule. The document may be reproduced from the Schedule by photographic copying that is clear, complete, and at least satisfies the type-size requirements set forth below for printing. In the alternative, the document may be printed and must meet the following criteria regarding typeface:

1. Words appearing in capital letters in the Schedule must be reproduced in capital letters and printed in bold-face roman type at least as large as ten-point modern type and at least two points leaded.

2. Words appearing in lower-case letters must be reproduced in lower-case roman type at least as large as ten point modern type and at least two points leaded.

3. Words that are underlined in the document must be underlined in reproduction and appear in bold-faced roman type at least as large as ten point modern type and at least two points leaded, and meet the criteria for lower-case or capital letters in paragraphs (1) and (2)

above, whichever is applicable.

E. Recipients of the document must not be charged any fee for the document.

F. The content of the Schedule is as follows:

[next page]

Important Information on Penny Stocks

This statement is required by the U.S. Securities and Exchange Commission (SEC) and contains important information on penny stocks. Your broker-dealer is required to obtain your signature to show that you have received this statement before your first trade in a penny stock. You are urged to read this statement before signing and before making a purchase or sale of a penny stock.

Penny stocks can be very risky.

[sbull] Penny stocks are low-priced shares of small companies not traded on an exchange or quoted on NASDAQ. Prices often are not available. Investors in penny stocks often are unable to sell stock back to the dealer that sold them the stock. Thus, you may lose your investment. Be cautious of newly issued penny stock.

[sbull] Your salesperson is not an impartial advisor but is paid to sell you the stock. Do not rely only on the salesperson, but seek outside advice before you buy any stock. If you have problems with a salesperson, contact the firm's compliance officer or the regulators listed below.

Information you should get.

[sbull] Before you buy penny stock, federal law requires your salesperson to tell you the ``offer'' and the ``bid'' on the stock, and the ``compensation'' the salesperson and the firm receive for the trade. The firm also must

[[Page 364]]

mail a confirmation of these prices to you after the trade.

[sbull] You will need this price information to determine what profit, if any, you will have when you sell your stock. The offer price is the wholesale price at which the dealer is willing to sell stock to other dealers. The bid price is the wholesale price at which the dealer is willing to buy the stock from other dealers. In its trade with you, the dealer may add a retail charge to these wholesale prices as compensation (called a ``markup'' or ``markdown'').

[sbull] The difference between the bid and the offer price is the dealer's ``spread.'' A spread that is large compared with the purchase price can make a resale of a stock very costly. To be profitable when you sell, the bid price of your stock must rise above the amount of this spread and the compensation charged by both your selling and purchasing dealers. If the dealer has no bid price, you may not be able to sell the stock after you buy it, and may lose your whole investment.

Brokers' duties and customer's rights and remedies.

[sbull] If you are a victim of fraud, you may have rights and remedies under state and federal law. You can get the disciplinary history of a salesperson or firm from the NASD at 1-800-289-9999, and additional information from your state securities official, at the North American Securities Administrators Association's central number: (202) 737-0900. You also may contact the SEC with complaints at (202) 272-7440.

[next page]

Further Information

The securities being sold to you have not been approved or disapproved by the Securities and Exchange Commission. Moreover, the Securities and Exchange Commission has not passed upon the fairness or the merits of this transaction nor upon the accuracy or adequacy of the information contained in any prospectus or any other information provided by an issuer or a broker or dealer.

Generally, penny stock is a security that:

[sbull] Is priced under five dollars;

[sbull] Is not traded on a national stock exchange or on NASDAQ (the NASD's automated quotation system for actively traded stocks);

[sbull] May be listed in the ``pink sheets'' or the NASD OTC Bulletin Board;

[sbull] Is issued by a company that has less than $5 million in net tangible assets and has been in business less than three years, by a company that has under $2 million in net tangible assets and has been in business for at least three years, or by a company that has revenues of $6 million for 3 years.

Use Caution When Investing in Penny Stocks

1. Do not make a hurried investment decision. High-pressure sales techniques can be a warning sign of fraud. The salesperson is not an impartial advisor, but is paid for selling stock to you. The salesperson also does not have to watch your investment for you. Thus, you should think over the offer and seek outside advice. Check to see if the information given by the salesperson differs from other information you may have. Also, it is illegal for salespersons to promise that a stock will increase in value or is risk-free, or to guarantee against loss. If you think there is a problem, ask to speak with a compliance official at the firm, and, if necessary, any of the regulators referred to in this statement.

2. Study the company issuing the stock. Be wary of companies that have no operating history, few assets, or no defined business purpose. These may be sham or ``shell'' corporations. Read the prospectus for the company carefully before you invest. Some dealers fraudulently solicit investors' money to buy stock in sham companies, artificially inflate the stock prices, then cash in their profits before public investors can sell their stock.

3. Understand the risky nature of these stocks. You should be aware that you may lose part or all of your investment. Because of large dealer spreads, you will not be able to sell the stock immediately back to the dealer at the same price it sold the stock to you. In some cases, the stock may fall quickly in value. New companies, whose stock is sold in an ``initial public offering,'' often are riskier investments. Try to find out if the shares the salesperson wants to sell you are part of such an offering. Your salesperson must give you a ``prospectus'' in an initial public offering, but the financial condition shown in the prospectus of new companies can change very quickly.

4. Know the brokerage firm and the salespeople with whom you are dealing. Because of the nature of the market for penny stock, you may have to rely solely on the original brokerage firm that sold you the stock for prices and to buy the stock back from you. Ask the National Association of Securities Dealers, Inc. (NASD) or your state securities regulator, which is a member of the North American Securities Administrators Association, Inc. (NASAA), about the licensing and disciplinary record of the brokerage firm and the salesperson contacting you. The telephone numbers of the NASD and NASAA are listed on the first page of this document.

5. Be cautious if your salesperson leaves the firm. If the salesperson who sold you the stock leaves his or her firm, the firm may reassign your account to a new salesperson. If you have problems, ask to speak to the firm's branch office manager or a compliance

[[Page 365]]

officer. Although the departing salesperson may ask you to transfer your stock to his or her new firm, you do not have to do so. Get information on the new firm. Be wary of requests to sell your securities when the salesperson transfers to a new firm. Also, you have the right to get your stock certificate from your selling firm. You do not have to leave the certificate with that firm or any other firm.

Your Rights

Disclosures to you. Under penalty of federal law, your brokerage firm must tell you the following information at two different times--before you agree to buy or sell a penny stock, and after the trade, by written confirmation:

[sbull] The bid and offer price quotes for penny stock, and the number of shares to which the quoted prices apply. The bid and offer quotes are the wholesale prices at which dealers trade among themselves. These prices give you an idea of the market value of the stock. The dealer must tell you these price quotes if they appear on an automated quotation system approved by the SEC. If not, the dealer must use its own quotes or trade prices. You should calculate the spread, the difference between the bid and offer quotes, to help decide if buying the stock is a good investment.

A lack of quotes may mean that the market among dealers is not active. It thus may be difficult to resell the stock. You also should be aware that the actual price charged to you for the stock may differ from the price quoted to you for **100** shares. You should therefore determine, before you agree to a purchase, what the actual sales price (before the markup) will be for the exact number of shares you want to buy.

[sbull] The brokerage firm's compensation for the trade. A markup is the amount a dealer adds to the wholesale offer price of the stock and a markdown is the amount it subtracts from the wholesale bid price of the stock as compensation. A markup/markdown usually serves the same role as a broker's commission on a trade. Most of the firms in the penny stock market will be dealers, not brokers.

[sbull] The compensation received by the brokerage firm's salesperson for the trade. The brokerage firm must disclose to you, as a total sum, the cash compensation of your salesperson for the trade that is known at the time of the trade. The firm must describe in the written confirmation the nature of any other compensation of your salesperson that is unknown at the time of the trade.

In addition to the items listed above, your brokerage firm must send to you:

[sbull] Monthly account statements. In general, your brokerage firm must send you a monthly statement that gives an estimate of the value of each penny stock in your account, if there is enough information to make an estimate. If the firm has not bought or sold any penny stocks for your account for six months, it can provide these statements every three months.

A Written Statement of Your Financial Situation and Investment Goals. In general, unless you have had an account with your brokerage firm for more than one year, or you have previously bought three different penny stocks from that firm, your brokerage firm must send you a written statement for you to sign that accurately describes your

financial situation, your investment experience, and your investment goals, and that contains a statement of why your firm decided that penny stocks are a suitable investment for you. The firm also must get your written consent to buy the penny stock.

Legal remedies. If penny stocks are sold to you in violation of your rights listed above, or other federal or state securities laws, you may be able to cancel your purchase and get your money back. If the stocks are sold in a fraudulent manner, you may be able to sue the persons and firms that caused the fraud for damages. If you have signed an arbitration agreement, however, you may have to pursue your claim through arbitration. You may wish to contact an attorney. The SEC is not authorized to represent individuals in private litigation.

However, to protect yourself and other investors, you should report any violations of your brokerage firm's duties listed above and other securities laws to the SEC, the NASD, or your state securities administrator at the telephone numbers on the first page of this document. These bodies have the power to stop fraudulent and abusive activity of salespersons and firms engaged in the securities business. Or you can write to the SEC at 450 Fifth St., NW., Washington, DC 20549; the NASD at 1735 K Street, NW., Washington, DC 20006; or NASAA at 555 New Jersey Avenue, NW., Suite 750, Washington, DC 20001. NASAA will give you the telephone number of your state's securities agency. If there is any disciplinary record of a person or a firm, the NASD, NASAA, or your state securities regulator will send you this information if you ask for it.

Market Information

The market for penny stocks. Penny stocks usually are not listed on an exchange or quoted on the NASDAQ system. Instead, they are traded between dealers on the telephone in the ``over-the-counter'' market. The NASD's OTC Bulletin Board also will contain information on some penny stocks. At times, however, price information for these stocks is not publicly available.

Market domination. In some cases, only one or two dealers, acting as ``market makers,'' may be buying and selling a given stock. You should first ask if a firm is acting as a broker

[[Page 366]]

(your agent) or as a dealer. A dealer buys stock itself to fill your order or already owns the stock. A market maker is a dealer who holds itself out as ready to buy and sell stock on a regular basis. If the firm is a market maker, ask how many other market makers are dealing in the stock to see if the firm (or group of firms) dominates the market. When there are only one or two market makers, there is a risk that the dealer or group of dealers may control the market in that stock and set prices that are not based on competitive forces. In recent years, some market makers have created fraudulent markets in certain penny stocks, so that stock prices rose suddenly, but collapsed just as quickly, at a loss to investors.

Mark-ups and mark-downs. The actual price that the customer pays usually includes the mark-up or mark-down. Markups and markdowns are direct profits for the firm and its salespeople, so you should be aware of such amounts to assess the overall value of the trade.

The ``spread.'' The difference between the bid and offer price is the spread. Like a mark-up or mark-down, the spread is another source of profit for the brokerage firm and compensates the firm for the risk of owning the stock. A large spread can make a trade very expensive to an investor. For some penny stocks, the spread between the bid and offer

may be a large part of the purchase price of the stock. Where the bid price is much lower than the offer price, the market value of the stock must rise substantially before the stock can be sold at a profit. Moreover, an investor may experience substantial losses if the stock must be sold immediately.

Example: If the bid is $0.04 per share and the offer is $0.10 per share, the spread (difference) is $0.06, which appears to be a small amount. But you would lose $0.06 on every share that you bought for $0.10 if you had to sell that stock immediately to the same firm. If you had invested $5,000 at the $0.10 offer price, the market maker's repurchase price, at $0.04 bid, would be only $2,000; thus you would lose $3,000, or more than half of your investment, if you decided to sell the stock. In addition, you would have to pay compensation (a ``mark-up,'' ``mark-down,'' or commission) to buy and sell the stock. \1/4\

In addition to the amount of the spread, the price of your stock must rise enough to make up for the compensation that the dealer charged you when it first sold you the stock. Then, when you want to resell the stock, a dealer again will charge compensation, in the form of a markdown. The dealer subtracts the markdown from the price of the stock when it buys the stock from you. Thus, to make a profit, the bid price of your stock must rise above the amount of the original spread, the markup, and the markdown.

Primary offerings. Most penny stocks are sold to the public on an ongoing basis. However, dealers sometimes sell these stocks in initial public offerings. You should pay special attention to stocks of companies that have never been offered to the public before, because the market for these stocks is untested. Because the offering is on a first-time basis, there is generally no market information about the stock to help determine its value. The federal securities laws generally require broker-dealers to give investors a ``prospectus,'' which contains information about the objectives, management, and financial condition of the issuer. In the absence of market information, investors should read the company's prospectus with special care to find out if the stocks are a good investment. However, the prospectus is only a description of the current condition of the company. The outlook of the start-up companies described in a prospectus often is very uncertain.

For more information about penny stocks, contact the Office of Filings, Information, and Consumer Services of the U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, (202) 272-7440.

[57 FR 18035, Apr. 28, 1992, as amended at 57 FR 31446, July 16, 1992; 58 FR 37417, July 12, 1993]

National and Affiliated Securities Associations

[Code of Federal Regulations]
[Title 17, Volume 3]
[Revised as of April 1, 2002]
From the U.S. Government Printing Office via GPO Access
[CITE: 17CFR240.15c2-11]

[Page 288-292]

TITLE 17--COMMODITY AND SECURITIES EXCHANGES

CHAPTER II--SECURITIES AND EXCHANGE COMMISSION (CONTINUED)

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934--Table of C

Subpart A--Rules and Regulations Under the Securities Exchange Act of 1934

Sec. 240.**15c2-11** Initiation or resumption of quotations without specific informatio

Preliminary Note:

Brokers and dealers may wish to refer to Securities Exchange Act Release No. 29094 (April 17, 1991), for a discussion of procedures for gathering and reviewing the information required by this rule and the requirement that a broker or dealer have a reasonable basis for believing that the information is accurate and obtained from reliable sources.

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for a broker or dealer to publish any quotation for a security or, directly or indirectly, to submit any such quotation for publication, in any quotation medium (as defined in this section) unless such broker or dealer has in its records the documents and information required by this paragraph (for purposes of this section, ``paragraph (a) information''), and, based upon a review of the paragraph (a) information together with any other documents and information required by paragraph (b) of this section, has a reasonable basis under the circumstances for believing that the paragraph (a) information is accurate in all material respects, and that the sources of the paragraph (a) information are reliable. The information required pursuant to this paragraph is:

(1) A copy of the prospectus specified by section 10(a) of the Securities Act of 1933 for an issuer that has filed a registration statement under the Securities Act of 1933, other than a registration statement on Form F-6, which became effective less than 90 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, Provided That such registration statement has not thereafter been the subject of a stop order which is still in effect when the quotation is published or submitted; or

(2) A copy of the offering circular provided for under Regulation A under the Securities Act of 1933 for an issuer that has filed a notification under Regulation A and was authorized to commence the offering less than 40 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, Provided That the offering circular provided for under Regulation A has not thereafter become the subject of a suspension order which is still in effect when the quotation is published or submitted; or

(3) A copy of the issuer's most recent annual report filed pursuant to section 13 or 15(d) of the Act or a copy of the annual statement

referred to in section 12(g)(2)(G)(i) of the Act, in the case of an issuer required to file reports pursuant to section 13 or 15(d) of the Act or

[[Page 289]]

an issuer of a security covered by section 12(g)(2)(B) or (G) of the Act, together with any quarterly and current reports that have been filed under the provisions of the Act by the issuer after such annual report or annual statement; Provided, however, That until such issuer has filed its first annual report pursuant to section 13 or 15(d) of the Act or annual statement referred to in section 12(g)(2)(G)(i) of the Act, the broker or dealer has in its records a copy of the prospectus specified by section 10(a) of the Securities Act of 1933 included in a registration statement filed by the issuer under the Securities Act of 1933, other than a registration statement on Form F-6, that became effective within the prior 16 months, or a copy of any registration statement filed by the issuer under section 12 of the Act that became effective within the prior 16 months, together with any quarterly and current reports filed thereafter under section 13 or 15(d) of the Act; and Provided further, That the broker or dealer has a reasonable basis under the circumstances for believing that the issuer is current in filing annual, quarterly, and current reports filed pursuant to section 13 or 15(d) of the Act, or, in the case of an insurance company exempted from section 12(g) of the Act by reason of section 12(g)(2)(G) thereof, the annual statement referred to in section 12(g)(2)(G)(i) of the Act; or

(4) The information furnished to the Commission pursuant to Sec. 240.12g3-2(b) since the beginning of the issuer's last fiscal year, in the case of an issuer exempt from section 12(g) of the Act by reason of compliance with the provisions of Sec. 240.12g3-2(b), which information the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer; or

(5) The following information, which shall be reasonably current in relation to the day the quotation is submitted and which the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer:

(i) The exact name of the issuer and its predecessor (if any);

(ii) The address of its principal executive offices;

(iii) The state of incorporation, if it is a corporation;

(iv) The exact title and class of the security;

(v) The par or stated value of the security;

(vi) The number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year;

(vii) The name and address of the transfer agent;

(viii) The nature of the issuer's business;

(ix) The nature of products or services offered;

(x) The nature and extent of the issuer's facilities;

(xi) The name of the chief executive officer and members of the board of directors;

(xii) The issuer's most recent balance sheet and profit and loss and retained earnings statements;

(xiii) Similar financial information for such part of the 2 preceding fiscal years as the issuer or its predecessor has been in existence;

(xiv) Whether the broker or dealer or any associated person is affiliated, directly or indirectly with the issuer;

(xv) Whether the quotation is being published or submitted on behalf

of any other broker or dealer, and, if so, the name of such broker or dealer; and

(xvi) Whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

If such information is made available to others upon request pursuant to this paragraph, such delivery, unless otherwise represented, shall not constitute a representation by such broker or dealer that such information is accurate, but shall constitute a representation by such broker or dealer that the information is reasonably current in relation to the day the quotation is submitted,

[[Page 290]]

that the broker or dealer has a reasonable basis under the circumstances for believing the information is accurate in all material respects, and that the information was obtained from sources which the broker or dealer has a reasonable basis for believing are reliable. This paragraph (a)(5) shall not apply to any security of an issuer included in paragraph (a)(3) of this section unless a report or statement of such issuer described in paragraph (a)(3) of this section is not reasonably available to the broker or dealer. A report or statement of an issuer described in paragraph (a)(3) of this section shall be ``reasonably available'' when such report or statement is filed with the Commission.

(b) With respect to any security the quotation of which is within the provisions of this section, the broker or dealer submitting or publishing such quotation shall have in its records the following documents and information:

(1) A record of the circumstances involved in the submission of publication of such quotation, including the identity of the person or persons for whom the quotation is being submitted or published and any information regarding the transactions provided to the broker or dealer by such person or persons;

(2) A copy of any trading suspension order issued by the Commission pursuant to section 12(k) of the Act respecting any securities of the issuer or its predecessor (if any) during the 12 months preceding the date of the publication or submission of the quotation, or a copy of the public release issued by the Commission announcing such trading suspension order; and

(3) A copy or a written record of any other material information (including adverse information) regarding the issuer which comes to the broker's or dealer's knowledge or possession before the publication or submission of the quotation.

(c) The broker or dealer shall preserve the documents and information required under paragraphs (a) and (b) of this section for a period of not less than three years, the first two years in an easily accessible place.

(d)(1) For any security of an issuer included in paragraph (a)(5) of this section, the broker or dealer submitting the quotation shall furnish to the interdealer quotation system (as defined in paragraph (e)(2) of this section), in such form as such system shall prescribe, at least 3 business days before the quotation is published or submitted, the information regarding the security and the issuer which such broker or dealer is required to maintain pursuant to said paragraph (a)(5) of this section.

(2) For any security of an issuer included in paragraph (a)(3) of this section,

(i) A broker-dealer shall be in compliance with the requirement to obtain current reports filed by the issuer if the broker-dealer obtains all current reports filed with the Commission by the issuer as of a date up to five business days in advance of the earlier of the date of submission of the quotation to the quotation medium and the date of submission of the paragraph (a) information pursuant to Schedule H of the By-Laws of the National Association of Securities Dealers, Inc.; and

(ii) A broker-dealer shall be in compliance with the requirement to obtain the annual, quarterly, and current reports filed by the issuer, if the broker-dealer has made arrangements to receive all such reports when filed by the issuer and it has regularly received reports from the issuer on a timely basis, unless the broker-dealer has a reasonable basis under the circumstances for believing that the issuer has failed to file a required report or has filed a report but has not sent it to the broker-dealer.

(e) For purposes of this section:

(1) Quotation medium shall mean any ``interdealer quotation system'' or any publication or electronic communications network or other device which is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.

(2) Interdealer quotation system shall mean any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers.

[[Page 291]]

(3) Except as otherwise specified in this rule, quotation shall mean any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that he wishes to advertise his general interest in buying or selling a particular security.

(4) Issuer, in the case of quotations for American Depositary Receipts, shall mean the issuer of the deposited shares represented by such American Depositary Receipts.

(f) The provisions of this section shall not apply to:

(1) The publication or submission of a quotation respecting a security admitted to trading on a national securities exchange and which is traded on such an exchange on the same day as, or on the business day next preceding, the day the quotation is published or submitted.

(2) The publication or submission by a broker or dealer, solely on behalf of a customer (other than a person acting as or for a dealer), of a quotation that represents the customer's indication of interest and does not involve the solicitation of the customer's interest; Provided, however, That this paragraph (f)(2) shall not apply to a quotation consisting of both a bid and an offer, each of which is at a specified price, unless the quotation medium specifically identifies the quotation as representing such an unsolicited customer interest.

(3)(i) The publication or submission, in an interdealer quotation system that specifically identifies as such unsolicited customer indications of interest of the kind described in paragraph (f)(2) of this section, of a quotation respecting a security which has been the subject of quotations (exclusive of any identified customer interests) in such a system on each of at least 12 days within the previous 30 calendar days, with no more than 4 business days in succession without a quotation; or

(ii) The publication or submission, in an interdealer quotation system that does not so identify any such unsolicited customer indications of interest, of a quotation respecting a security which has been the subject of both bid and ask quotations in an interdealer quotation system at specified prices on each of at least 12 days within the previous 30 calendar days, with no more than 4 business days in succession without such a two-way quotation;

(iii) A dealer acting in the capacity of market maker, as defined in section 3(a)(38) of the Act, that has published or submitted a quotation respecting a security in an interdealer quotation system and such quotation has qualified for an exception provided in this paragraph (f)(3), may continue to publish or submit quotations for such security in the interdealer quotation system without compliance with this section unless and until such dealer ceases to submit or publish a quotation or ceases to act in the capacity of market maker respecting such security.

(4) The publication or submission of a quotation respecting a municipal security.

(5) The publication or submission of a quotation respecting a security that is authorized for quotation in the NASDAQ system (as defined in Sec. 240.11Ac1-2(a)(3) of this chapter), and such authorization is not suspended, terminated, or prohibited.

(g) The requirement in paragraph (a)(5) of this section that the information with respect to the issuer be ``reasonably current'' will be presumed to be satisfied, unless the broker or dealer has information to the contrary, if:

(1) The balance sheet is as of a date less than 16 months before the publication or submission of the quotation, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the publication or submission of the quotation, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the publication or submission of the quotation.

(2) Other information regarding the issuer specified in paragraph (a)(5) of this section is as of a date within 12 months prior to the publication or submission of the quotation.

[[Page 292]]

(h) This section shall not prohibit any publication or submission of any quotation if the Commission, upon written request or upon its own motion, exempts such quotation either unconditionally or on specified terms and conditions, as not constituting a fraudulent, manipulative or deceptive practice comprehended within the purpose of this section.

[36 FR 18641, Sept. 18, 1971, as amended at 41 FR 22826, June 7, 1976; 49 FR 45123, Nov. 15, 1984; 56 FR 19156, Apr. 25, 1991]

[Federal Register: November 2, 2001 (Volume 66, Number 213)]
[Rules and Regulations]
[Page 55817-55841]
From the Federal Register Online via GPO Access [wais.access.gpo.gov]
[DOCID:fr02no01-21]

Part III

Securities and Exchange Commission

---

17 CFR Parts 240 and 242

Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934; Final Rule

---

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 242

[Release No. 34-44992; File No. S7-26-98]
RIN 3235-AH04

Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; request for comments on Paperwork Reduction Act burden estimate.

SUMMARY: The Securities and Exchange Commission today is adopting amendments to its broker-dealer books and records rules. The amendments clarify and expand recordkeeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints, and certain other matters. In addition, the amendments expand the types of records that broker-dealers must maintain and require broker-dealers to maintain or promptly produce certain records at each office to which those records relate. These amendments are specifically designed to assist securities regulators when conducting sales practice examinations of broker-dealers, particularly examinations of local offices.

EFFECTIVE DATE: May 2, 2003.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 942-0131; Thomas K. McGowan, Assistant Director, at (202) 942-4886; or Bonnie L. Gauch, Attorney, at (202) 942-0765; Office of Risk Management and Control, Division of Market Regulation, United States Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1001.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Securities and Exchange Commission's (the ``Commission'') books and records rules, Rule 17a-3\1\ and Rule 17a-4 \2\ under the Securities Exchange Act of 1934 (``Exchange Act'')(hereinafter the ``Books and Records Rules''), specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept. The Commission has required that broker-dealers create and maintain certain records so that, among other things, the Commission, self-regulatory organizations (``SROs''), and State Securities Regulators \3\ (collectively ``securities regulatory authorities'') may conduct effective examinations of broker-dealers.

\1\ 17 CFR 240.17a-3.

\2\ 17 CFR 240.17a-4.

\3\ For purposes of this release, ``State Securities Regulators'' include, as described in Section 15(h) of the Exchange Act, ``the securities commissions (or any agency or office performing like functions) of the States.'' 15 U.S.C. 78o(h).

The Commission originally proposed amending the Books and Records Rules in 1996 in response to concerns raised by members of the North American Securities Administrator's Association (``NASAA'') regarding the adequacy of those Rules.\4\ On October 11, 1996, the National Securities Market Improvement Act of 1996 (``NSMIA'') was enacted.\5\ NSMIA prohibits States from establishing books and records rules that differ from, or are in addition to, the Commission's rules. Prior to NSMIA many States had laws or rules that required broker-dealers to

make and keep certain books and records that allowed the State Securities Regulators to conduct examinations and investigations to review for, among other things, sales practice violations.\6\ NSMIA also provides that the Commission must consult periodically with the States concerning the adequacy of the Commission's Books and Records Rules,\7\ particularly relating to the need by State Securities Regulators to have records readily accessible for their examinations.\8\

\4\ See Exchange Act Release No. 37850 (October 22, 1996), 61 FR 55593 (Oct. 28, 1996) (``Proposing Release'' and/or ``Proposal'') (File No. S7-27-96).

\5\ Pub. L. No. 104-290, 110 Stat. 3416 (1996).

\6\ E.g., violations of State suitability and fraud laws, or federal regulations.

\7\ 15 U.S.C. 78o(h).

\8\ 142 Cong.Rec.S. 12093, S12094 (October 1, 1996) (statement of Sen. Dodd) (``It is the intent of the conferees that the SEC work closely with the States to determine what records should be maintained at branch offices and to establish a mechanism so that States could require such records be kept in the branch office, rather than at a back office halfway across the Nation.'').

The Commission, recognizing the vital role that State regulators play in providing for customer protection, issued the Proposing Release, in part, to enhance the ability of the State Securities Regulators to conduct effective and efficient sales practice examinations of activities within their respective States, including those involving smaller broker-dealer offices. By adopting these rules, the Commission enables the State regulators to adopt and enforce similar rules on a State level, to support their examination responsibilities, and investigatory and enforcement requirements. An important aspect of the amendments is that broker-dealers are required to produce records at offices within a State. Moreover, many of these amendments require broker-dealers to make or keep records currently kept by broker-dealers as a matter of business practice or to comply with SRO rules. However, unless these requirements are adopted as Commission rules, the State regulators are unable to apply or enforce them at the State level.

II. Proposing and Reproposing Releases

In response to the comments received on the Proposing Release, the Commission substantially modified the amendments, and reproposed them to allow for public comment on the modifications.\9\ In response to the reproposal, the Commission received approximately 115 comment letters from various groups, including broker-dealers, law firms representing broker-dealers, industry associations, and State Securities Regulators. Generally, State Securities Regulators supported the rules as reproposed, but suggested some minor changes. While broker-dealers generally supported the Commission's efforts to adopt uniform books and records rules, they opposed various sections of the reproposed rules. In particular, firms were opposed to the requirements to periodically

update the customer account record and to maintain records at local offices. As discussed in the respective sections throughout this release, the Commission has substantially modified the content of the re-proposed amendments and incorporated many of the suggested changes into the final rules.

\9\ Exchange Act Release No. 40518 (Oct. 2, 1998), 63 FR 54404 (Oct. 9, 1998) (the ``Reproposing Release'' and/or ``Reproposal''). The staff of the Division of Market Regulation has prepared a summary of the comment letters received on the reproposed rules and rule amendments (hereinafter referred to as ``Comment Summary''). Copies of the comment letters and the Comment Summary have been placed in Public Reference File No. S7-26-98 and are available for inspection in the Commission's Public Reference Room.

To a significant degree, the amendments to Rules 17a-3 and 17a-4 adopted by the Commission track existing SRO requirements and certain State regulations that were in place prior to NSMIA. In addition, they largely represent a codification of prudent recordkeeping practices of many broker-dealers. Accordingly, many portions of the Books and Records Rule amendments should not present additional burdens for most broker-dealers.

[[**Page** 55819]]

III. Amendments to Rule 17a-3

In brief, the amendments to present Rule 17a-3 include revisions to the information that must be recorded on order tickets, and new requirements to: create certain records relating to associated persons; collect certain account record information and verify that information with customers periodically; create a record of customer complaints; create a record indicating compliance with applicable advertising rules; and create records identifying persons responsible for establishing procedures and persons able to explain the broker-dealer's records to a regulator.

A. Memoranda of Brokerage Orders and Dealer Transactions

Rule 17a-3 has been amended to require that a brokerage order ticket contain the identity of the associated person, if any, responsible for the account and any other person who entered or accepted the order on behalf of the customer, and whether it was entered subject to discretionary authority. In addition, a brokerage order ticket must include the time at which the broker-dealer received a customer order, even if the order is subsequently transmitted for execution.\10\ A dealer ticket must include information regarding any modifications to the order.\11\ This will allow securities regulators to better focus their examinations and investigations because they will be able to identify certain types of violative activities and the individuals responsible for those activities more easily.

\10\ 17 CFR 240.17a-3(a)(6). Most broker-dealers are currently required to record the time the order was received from a customer under the National Association of Securities Dealers' (``NASD'') Order Audit Trail System (``OATS'') rules (NASD rules 6950 through 6957 and 3110) (hereinafter ``OATS rules'') (See specifically NASD rules 6954(b)(16) and 3110(h)), and New York Stock Exchange (``NYSE'') rules 123 and 410A.

\11\ 7 CFR 240.17a-3(a)(7).

The Commission clarified that the identity of the associated person responsible for the account must be included only if the broker-dealer assigns to an associated person responsibility for certain accounts. This modification was made in response to broker-dealer comment letters that noted some firms do not assign a particular associated person to each account, and some firms allow customers to enter orders directly into a broker-dealer's systems, such as through an on-line trading account. Further, this modification addresses the concerns of some commenters that without a qualifying phrase, such as ``if any,'' the rule may be interpreted erroneously as placing on firms an affirmative obligation to assign an associated person to each account.

If a firm has assigned identification numbers or codes to the persons entering customer orders to comply with the requirement to record the identity of the person entering customer orders, a broker-dealer may record the identification number or code on the order ticket instead of the associated person's name. Further, if the person entering a customer order has been assigned to a computer terminal but does not have a specific identification number or code, it is acceptable for the broker-dealer to identify the number or code of a computer terminal at which an order was entered. In either case, upon request by a representative of a securities regulatory authority, the firm must provide the actual identity of the person who entered the order. Either of these alternatives may be satisfied by using a companion record to the order tickets.\12\

\12\ E.g., a firm may satisfy this requirement by using the record listing any internal identification number or code assigned to associated persons which is required under new Rule 17a-3(a)(12)(ii) (17 CFR 240.17a-3(a)(12)(ii)). Additionally, the Commission believes this requirement is consistent with the NASD's OATS rules.

With these amendments, paragraphs (a)(6) and (a)(7) require that broker-dealers record the identity of ``any [person other than the associated person responsible for the account] who entered or accepted the order on behalf of the customer.'' In response to comments by the online brokerage community, the Commission included, after this requirement, the phrase, ``if a customer entered the order on an electronic system, a notation of such entry.'' Because most firms that accept orders through an electronic system already identify, for supervisory purposes, which orders were entered directly by a customer,

this requirement will not create much additional burden on the firms. Further, it will assist them in identifying for securities regulatory authorities why certain tickets do not identify the associated person who received the order from the customer.

One commenter argued that firms that primarily accept ``unsolicited'' orders and do not pay transaction-based commissions should not be required to include on the order ticket information regarding associated persons because no sales practice concerns would be implicated in these types of transactions. However, the Commission believes that recording the identity of the associated person on a broker-dealer's order tickets is essential for adequate surveillance of, and accountability for, transactions.

One commenter wrote that for some transactions the time of entry frequently is simultaneous or nearly simultaneous with the time the order is received, and suggested that under these conditions, the firm should not have to make a separate entry for each time. In those situations, it must be clear from the order ticket that the time of receipt was the same as the time of entry. However, the time recorded must be accurate and this should not be construed as an exception to allow firms to use an approximate time for one or both entries.\13\

\13\ A number of firms have asked for guidance on the meaning of the term ``to the extent feasible.'' The time of execution should be included on the order ticket except for situations in which it may be impossible to determine the precise time when the transaction was executed; however, in that case the broker-dealer must note the approximate time of execution. Exchange Act Release No. 3040 (Oct. 13, 1941), 11 FR 10984. The Commission has stated that the ``phrase ``to the extent feasible'' was intended to be applicable only in exceptional circumstances where it might be actually impossible to determine the exact time of execution.'' Exchange Act Release No. 13508 (May 5, 1977) 42 FR 25318. However, in that case the broker-dealer must note the approximate time of execution.

Finally, the Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.\14\ These documents would include the information that is important for and specific to the particular type of transaction. Hence, the Commission has added paragraph (a)(6)(ii) under Rule 17a-3 to allow firms to keep a copy of the application or subscription document instead of making a separate record as to transactions described in the exemption. This paragraph would also exempt transactions such as automatic dividend reinvestments. The Commission views this additional paragraph as a codification of current industry practice, and it is limited to these types of transactions.

\14\ This is referred to elsewhere in the rules as a ``subscription-way basis'' transaction. See 17 CFR.15c3-1(a)(2)(v).

B. Associated Person Records

1. New Records Concerning Associated Persons

Rule 17a-3(a)(12) requires a firm to make records relating to associated persons of the firm, including information regarding the associated person's employment and disciplinary history. The amendments require a record listing all of a firm's associated

persons showing every office where each associated person regularly conducts business, and listing all internal identification numbers and the CRD number assigned to each associated person.\15\ This will allow securities regulators to identify where associated persons work, and to read various records which may identify the associated persons solely through the use of identification numbers. Also, three technical changes were made from the rule as reproposed.\16\

\15\ 17 CFR 240.17a-3(a)(12)(ii).

\16\ First, reproposed paragraphs (a)(12)(ii) and (a)(12)(iii) have been moved to paragraph (a)(19) of Rule 17a-3 to keep all requirements relating to compensation records in the same section (most agreements between associated persons and broker-dealers relate to compensation in some manner). Second, reproposed paragraphs (a)(12)(iv) and (a)(12)(v) have been combined into new paragraph (a)(12)(ii). And finally, the Commission has deleted the references to local offices and state record depositories to make this paragraph consistent with the changes to the definition of ``office'' in paragraph (g)(1) of Rule 17a-3.

---

2. The Definition of Associated Person

The Commission had proposed to eliminate from Rule 17a-3 a definition of ``associated person'' and instead use the definition of ``associated person'' as defined in sections 3(a)(18) and 3(a)(21) of the Exchange Act. However, the statutory definition of ``associated person of a broker or dealer'' in section 3(a)(18) specifically excludes those persons whose functions are clerical or ministerial from the definition solely for purposes of section 15(b) of the Exchange Act. Current Rule 17a-3 excludes those persons from the recordkeeping requirements. The Commission has determined that those persons should continue to be exempt from the recordkeeping requirements of Rules 17a-3 and 17a-4. Therefore, the Commission believes it is appropriate to retain a definition of the term ``associated person'' in the rule. This definition has been moved to paragraph (g), however, and has been modified for the sake of uniformity to incorporate the definitions of ``associated person of a member'' and ``associated person of a broker or dealer'' as set forth in sections 3(a)(21) and 3(a)(18) of the Exchange Act.\17\ In addition, for purposes of Rules 17a-3 and 17a-4, the Commission has excluded from the definition persons whose functions are solely clerical or ministerial. In order to avoid redundancy and

achieve greater consistency in interpretation, this phrase shall be interpreted in the same manner as the phrase ``solely clerical and ministerial'' is interpreted under section 3(a)(18) of the Exchange Act.

\17\ 15 U.S.C. 78c(a)(21) and 15 U.S.C. 78c(a)(18).

The Exchange Act provisions define an associated person to include any partner, officer, director, or branch manager of a broker-dealer (any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a broker-dealer, or any employee of a broker-dealer. This includes order-takers. The Commission interprets the term associated person to include any independent contractor, consultant, franchisee, or other person providing services to a broker-dealer equivalent to those services provided by the persons specifically referenced in the statute.\18\

\18\ The Commission has consistently taken the position that independent contractors (who are not themselves registered as broker-dealers) involved in the sale of securities on behalf of a broker-dealer are ``controlled by'' the broker-dealer, and, therefore, are associated persons of the broker-dealer. See, e.g., In the Matter of William V. Giordano, 61 S.E.C. Dkt. 345, Exchange Act Release No. 36742 (Jan. 19, 1996) (in finding that an officer of a broker-dealer firm failed reasonably to supervise an independent contractor, the Commission found that the independent contractor was an ``associated person'' of the firm within the meaning of Section 3(a)(18) of the Exchange Act). See, also, Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon S. Macklin, NASD; Charles J. Henry, Chicago Board Options Exchange; Robert J. Birnbaum, American Stock Exchange; and John J. Phelan, NYSE, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P77,303 at P77,116 (Jun. 18, 1982); Hollinger v. Titan Capital Corp., 974 F.2d 1564, 1572-76 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991). A similar analysis would be applicable to other persons, such as consultants and franchisees, performing securities activities with or for the broker-dealer.

C. Customer Account Record

The Commission is adopting new Rule 17a-3(a)(17) \19\ under the Exchange Act, which requires broker-dealers to create a record containing certain minimum information as to each customer. The primary purpose of Rule 17a-3(a)(17) is to provide regulators, particularly State Securities Regulators, with access to books and records which enable them to review for compliance with suitability rules.\20\ Rule 17a-3(a)(17) also requires broker-dealers to furnish that information to each customer on a periodic basis. The rule should not be construed

to affect or supersede any Federal, State, or SRO requirement, including those relating to ``know your customer,'' suitability, or supervisory obligations.

\19\ This provision was reproposed as Rule 17a-3(a)(16).

\20\ Generally, suitability rules require that broker-dealers and their associated persons refrain from recommending transactions or investment strategies to a customer that would be ``unsuitable'' for that customer based upon the customer's situation. Factors that may be considered in assessing a customer's situation include the customer's age, financial situation, and investment experience or knowledge of the industry.

---

1. Account Record Information

The information required under new Rule 17a-3(a)(17)(i)(A) for each account with a natural person as a customer includes the customer's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and investment objectives. Most broker-dealers already collect this information to assist them in assessing customers' suitability or to comply with other rules. For accounts with more than one owner, the record should include personal information for each owner of the account; however, the record should reflect the investment objectives for the account and not the individual investment objectives for each ``joint'' owner named on the account. Further, financial information for the owners can be combined. For discretionary accounts, firms also must include as part of the account record the dated signature of each customer granting the discretionary authority and the dated signature of each natural person \21\ to whom discretionary authority was granted. In response to comments received, the Commission did not adopt the reproposed requirement that the account record include information regarding a customer's marital status and number of dependents.\22\

\21\ See NYSE Rule 408 and NASD Rule 2510(b).

\22\ See, e.g., Comment Letters from Raymond James, p. 4; Investment Management and Research, p. 3, and Mayer, Brown & Platt, pp. 6-7.

Under the final rule, the account record must indicate whether it has been signed by the associated person responsible for the account, and approved or accepted by a principal of the firm.\23\ This will identify for regulators the persons responsible for accepting a particular account on behalf of the firm. Similar to the comments made regarding order tickets, some commenters stated that they do not always assign an associated person to each account. Therefore, the Commission has added the phrase ``if any'' to the requirement that the account record indicate whether it has been approved by an associated person.

The account record still must indicate

[[Page 55821]]

whether it has been approved by a principal.\24\

\23\ 17 CFR 240.17a-3(a)(17)(i)(A). This requirement is consistent with SRO rules regarding the signatures of associated persons and principals when opening customer accounts. See NYSE Rule 405(3) and NASD Rule 3110(c)(1)(C).

\24\ The Commission believes that this requirement is consistent with SRO requirements regarding customer accounts such as those discussed above in footnote 23.

In the Reproposal, the Commission specifically sought comment on whether, for joint accounts, the firm should obtain the account record information for each individual. Most commenters that addressed this issue did not object to maintaining personal information for each owner of joint accounts. However, some commenters pointed out that it would be unnecessary and redundant to obtain individual information for certain types of joint accounts, such as a joint account of two spouses with similar information regarding income and net worth. These commenters also contended that the investment objectives should reflect the objectives for the account and not the objectives of the individual owners. In those cases, it is sufficient under paragraph (a)(17) of Rule 17a-3 \25\ that the account record reflect that portions of the account record information are the same for each owner of the account. It is acceptable for firms to combine joint owners' financial information as opposed to obtaining and maintaining that information separately for each of the joint owners. Lastly, the investment objectives recorded should be those for the account, and not those of the individual owners.

\25\ 17 CFR 240.17a-3(a)(17).

Some commenters requested clarification as to how this information must be maintained and whether all the information and signatures must be included on the same form.\26\ Although a broker-dealer must create a single record for each account, that record may consist of more than one document, such as two or more account applications.

\26\ See Comment Letters from Donaldson, Lufkin and Jenrette, p. 9, and the International Association for Financial Planning, pp. 2-3.

A broker-dealer is not required to furnish a copy of a customer's account record to the customer within thirty days when obtaining new information to complete the initial account record, required under Rule 17a-3(a)(17)(i)(A),\27\ for an account in existence on the effective date of the rule amendments. However, as stated in Rule 17a-3(a)(17)(i)(B)(1),\28\ broker-dealers must create a record indicating that the broker-dealer furnished these customers with a copy of the account record information within three years of the effective date of the rule.

\27\ 17 CFR 240.17a-3(a)(17)(i)(A).
\28\ 17 CFR 240.17a-3(a)(17)(i)(B)(1).

---

2. Furnishing the Account Record Information

Rule 17a-3(a)(17) requires that the firm periodically furnish account record information to the customer.\29\ The new requirement allows the customer to review the information regarding the account that the firm has on file and from which the associated person or the firm is making investment recommendations or suitability determinations for the account. The requirement to furnish this record to customers is designed to reduce the number of misunderstandings between customers and broker-dealers regarding the customer's situation or investment objectives. Firms may, of course, elect to provide this information to customers more frequently in order to coincide with other mailings.

\29\ Certain SRO rules already require that customer account records be sent to customers who open options accounts. See NASD Rule 2860(b)(16)(C) and IM-2860-2, and NYSE Rule 721(c) and Supplemental Material at .30 regarding options accounts.

Paragraph (a)(17) of the rule identifies four provisions that trigger the requirement that a broker-dealer furnish to a customer a copy of information contained in the account record.\30\ Those provisions include (i) the opening of a new account;\31\ (ii) the periodic updating of an account that must occur at least once every 36 months;\32\ (iii) a change of customer name or address;\33\ and (iv) a change of other customer information.\34\

\30\ 17 CFR 240.17a-3(a)(17)(i)(B)(1) through (B)(3).
\31\ 17 CFR 240.17a-3(a)(17)(i)(B)(1).
\32\ Id.
\33\ 17 CFR 240.17a-3(a)(17)(i)(B)(2).
\34\ 17 CFR 240.17a-3(a)(17)(i)(B)(3).

Although paragraph (a)(17)(i) of Rule 17a-3 requires broker-dealers

to periodically update customer records, the rule does not affect a broker-dealer's obligations under any SRO ``know your customer'' rules. It may be appropriate in certain circumstances for broker-dealers to obtain updated information from customers more often than once every 36 months.

Because different terms ascribed to categories of investment objectives may vary among firms, the firms must describe these terms when furnishing the account record to customers. When opening an account, the customer has the opportunity to question the meaning of the investment objective terms, but when the customer receives a copy of the account record at home, that customer may have forgotten or misunderstood the meaning of those terms. This requirement to describe investment objective terminology should help ensure that the customer and the firm have a mutual understanding of the meaning of each term.

Paragraph (a)(17) of Rule 17a-3 also provides that a broker-dealer is not required to include the customer's tax identification number and date of birth with the information provided to the customer. Several commenters suggested that unauthorized access to such information could facilitate the perpetration of fraud against the customer.\35\

\35\ See Comment Letters from Fidelity Investments, p. 5, Benefits Communication Corporation, p. 1, American Express Financial Advisors, Inc., p. 4, and Comerica Securities, p. 3.

The Commission did not adopt the portion of the rule as reproposed that would have required firms to send a notification of change of address to both the old and new addresses. This change was in response to comments that prudent business practice requires that this notification be sent only to the old address to prevent misdirection of account information. Therefore, as adopted, firms are required to send a notification of a change of address only to the old address.

Some commenters sought clarification as to whether the amendment required a separate mailing of the customer account record information. This rule does not require a separate mailing, and the Commission anticipates that firms will combine this mailing with other mailings. Further, the account record information may be printed on a customer's account statement. Finally, a firm may mail the customer a copy of the customer's complete account record reflecting any change of other account record information \36\ on or before the 30th day after the date the member, broker or dealer received notice of any change, or it may choose to send this notification with the next statement scheduled to be mailed to the customer.

\36\ 17 CFR 240.17a-3(a)(17)(i)(B)(4).

---

3. Explanation of the Neglect, Refusal, or Inability of a Customer To Provide Required Information

As adopted, Rule 17a-3(a)(17)(i)(C) does not require broker-dealers to include an explanation of the customer's neglect, refusal, or

inability to provide the required information. However, a broker-dealer is required to make a good faith effort to collect this information. If the account record does not include the required information, the broker-dealer would bear the burden of explaining why this information is not available. Rule 17a-3(a)(17)(i)(C) is

specifically limited in application to paragraph (a)(17), and does not apply to any other Federal or SRO rules regarding collections of information (e.g., Rule 17a-3(a)(9)).

4. Exemption From Account Record Information Requirements

A number of broker-dealer firms argued that the Commission should create an exemption from the account record information requirements of Rule 17a-3(a)(17)(i), contending that this record is intended to allow examiners to review for suitability, but broker-dealers are not subject to SRO suitability requirements for all of their accounts.\37\ Therefore, they argue, where they have no suitability obligation, they should not be required to obtain account record information. The Commission is adopting the account record requirements with an exemption for certain accounts,\38\ such that a broker-dealer is not required to create an account record for an account if the firm is not required (under any Federal or SRO rules) to make a suitability determination as to the account. However, the obligation to collect and record information of the type enumerated in Rule 17a-3(a)(17)(i)(A) may arise under SRO rules and interpretations. If, after the account is opened, the firm or its associated person engage in conduct that would subject the firm to any requirement to make a suitability determination, the firm must obtain the information before making such a recommendation. The firm would have to comply thereafter with the requirement to furnish customers with a copy of their account record for verification, under paragraph (a)(17)(i)(B)(1) of Rule 17a-3, but the account could re-qualify for the exemption.

\37\ See, e.g., NASD Rules 2310 and 2860(b)(16)(B), NYSE Rule 723, Chicago Board Options Exchange Rule 9.9, and Municipal Securities Rulemaking Board Rule G-19.

\37\ 17 CFR 240.17a-3(a)(17)(i)(D).

For accounts existing on the effective date of these amendments, a broker-dealer will not be required to create or update the account record if, within the 36-month period beginning on the effective date of this rule, the firm has not been required to make a suitability determination as to that account.

For the purposes of paragraph (a)(17)(i)(D) of Rule 17a-3, the term ``suitability determination'' should be interpreted broadly. A broker-dealer may have an obligation to perform a suitability determination under the Exchange Act,\39\ Commission rules,\40\ SRO rules,\41\ or common law.\42\ Rule 17a-3(a)(17) does not change or limit a broker-dealer's obligation to make a suitability determination.

\39\ Sections 10(b) and 15(c) (15 U.S.C. 78j(b) and 15 U.S.C. 78o(c)). See e.g., Hanley v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); F.J. Kaufman and Co., 50 S.E.C. 164 (1989); O'Connor v. R.F.Lafferty & Co., 965 F.2d 893 (10th Cir. 1992).

\40\ 17 CFR 240.10b-5 and 17 CFR 240.15c1-2.

\41\ See supra note 37.

\42\ If a recommendation is made, a suitability obligation arises irrespective of the medium used to deliver that recommendation. For example, a broker-dealer can make a recommendation in person, on a website, via telephone, mail, or email. A broker-dealer also can recommend a security online regardless of whether that recommendation is attributable to a specific registered representative. Whether a broker-dealer has made a recommendation is a question that can only be answered by considering all of the facts and circumstances. (See ``Suitability Hypotheticals,'' Report of Commissioner Laura S. Unger, Online Brokerage: Keeping Apace of Cyberspace, pp. 32-4. (Nov. 1999))

It is important to note that even if a broker-dealer is not required to create an account record under Rule 17a-3(a)(17) for an account, the firm must still comply with federal laws and regulations and SRO rules requiring collections of information regarding customer accounts, including paragraph (a)(9) of Rule 17a-3,\43\ NYSE Rule 405, and MSRB Rule G-8(a)(xi).

\43\ 17 CFR 240.17a-3(a)(9).

---

5. Applicability of Account Record Requirements and 36-Month Grace Period

The requirement to create an account record applies to both new and existing accounts. For accounts opened on or after the effective date of these amendments (``new accounts''), the firm must obtain the account record information required under Rule 17a-3(a)(17)(i)(A) when the account is opened.

As originally proposed, the grace period to obtain the customer account record information for accounts existing on the effective date of these amendments would have been one year. However, many commenters \44\ stated that with a large number of accounts it would be unduly burdensome to obtain the account record information within one year. Therefore, the Commission has provided broker-dealers with a 36-month grace period. Specifically, under paragraph (B)(1) of Rule 17a-3(a)(17)(i), for accounts existing on the effective date of these amendments, a firm will have 36 months to obtain the information required on the account record under paragraph (a)(17)(i)(A) of Rule 17a-3. The new 36-month furnishing cycle under paragraph (a)(17)(i)(B) of Rule 17a-3 will begin when the firm obtains the account record information within the initial 36-month grace period.

\44\ See, e.g., Comment Letter of Salomon Smith Barney, pp. 3-4.

---

6. Written Customer Agreements

New paragraph (a)(17)(iii) of Rule 17a-3 requires each broker-dealer to create a record for each account indicating that each customer was furnished with a copy of any written agreement entered into on or after the effective date of this paragraph pertaining to that account. This will allow customers to review the terms of agreements to which they are subject, and to better understand their rights and responsibilities (and those of the broker-dealer) under these agreements. In addition, if any customer specifically requests a copy of an agreement relating to their account, this paragraph would require that the broker-dealer maintain a record that it was provided to the customer.

D. Complaints

New paragraph (a)(18)(i) of Rule 17a-3 \45\ requires firms to make a record as to each associated person that includes every written customer complaint received by the firm concerning that associated person.\46\ This will allow securities regulators to quickly identify any trends, and focus examinations. This record must include complaints received electronically from customers. The rule requires that the record include the complainant's name, address, and account number; the date the complaint was received; the name of each associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. However, because firms already are required to keep originals of incoming written complaints,\47\ rather than make a separate record, firms have the option under this rule to keep the original complaint along with a record of the disposition of the complaint, if kept by name of associated person. This rule does not limit a broker-dealer's

responsibilities under SRO and other regulations that may require creation and maintenance of records regarding, or reporting of, oral complaints.

\45\ This paragraph was proposed as paragraph (a)(17) of Rule 17a-3.

\46\ This requirement is in addition to other recordkeeping requirements such as Rule 17a-4(b)(4), which requires firms to keep originals of all correspondence received. For example, if a broker-dealer firm received a written complaint regarding the firm itself, the firm would be required to keep that complaint under Rule 17a-4(b)(4). If the complaint related to a particular associated person, the firm would also be required to make a record of the complaint as to that associated person under Rule 17a-3(a)(18); however, the firm may keep one copy of the complaint to satisfy both Rules 17a-3(a)(18)(i) and 17a-4(b)(4).

\47\ See 17 CFR 240.17a-4(b)(4), and NASD Rule 3110(d).

Paragraph (ii) of Rule 17a-3(a)(18) requires firms to make a record indicating that each customer has been provided with a notice of the address and telephone number of the department of the firm to which any complaints may be directed.\48\ This will assist both customers and broker-dealers to ensure that complaints reach the proper person or department so they can be recorded, reported (if necessary), and answered. Some commenters requested clarification of whether, in an introducing/clearing relationship,\49\ the contact information should be that of the introducing firm, the clearing firm, or both. To the extent not otherwise required, this should be a matter of negotiation between the introducing firm and the clearing firm.\50\ If contact information is provided for both firms, the notification should clearly indicate which firm the customer should contact and for what purposes. Two other commenters requested clarification as to whether this notification could take the form of a notice on customer statements.\51\ The Commission believes that firms should have flexibility as to how they may deliver this notice to customers, and inserting the notice on a customer statement is one acceptable alternative.

\48\ This requirement expands on an existing interpretation of the Commission's financial responsibility rules and the Securities Investor Protection Act of 1970, which states that, for purposes of custody of securities, for a firm to qualify as an introducing firm with a lesser net capital requirement than a clearing firm, its customers must be treated as customers of the clearing firm. In addition, under that interpretation, the clearing firm must issue account statements directly to customers, and each account statement must contain the name, address, and telephone number of a responsible individual at the clearing firm whom a customer can contact with inquiries and complaints regarding the customer's account.

\49\ See, e.g., Comment Letter from Lawrence M. Lowman, p. 1.

\50\ See supra note 48; Exchange Act Release No. 31511 at note 21 and accompanying text, (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

\51\ See Comment Letters from the Discount Brokers, p. 7, and Donaldson, Lufkin & Jenrette, p. 10.

E. Compensation

Paragraph (a)(19)(i) of Rule 17a-3 requires firms to make a record as to each associated person listing each purchase and sale of a security \52\ attributable, for compensation purposes, to that associated person. Again, the purpose for this requirement is to allow securities regulators to quickly identify compensation trends and focus examinations. The record must include the amount of compensation (if monetary) and a description of the compensation (if non-monetary). Under this requirement, firms must make records of all commissions, concessions, overrides, and other compensation to the extent they are earned or accrued for transactions. In addition, if the compensation is non-monetary, that description should include an estimate of its value.

\52\ The phrase ``and the specific security,'' which appeared in the Reproposing Release, was not included in the Rule as adopted because it is redundant. The record ``listing all purchases and sales of securities for which the associated person was compensated'' must provide enough information to identify that purchase or sale to which the compensation was attributable.

The term ``non-monetary compensation'' includes compensation such as sales incentives, gifts, or trips that would be provided to associated persons if certain sales goals were achieved. Such non-monetary compensation should be recorded if directly related to sales. If sales would be counted toward achieving these goals, then a notation of the sales should be made regardless of whether that goal is actually achieved. Non-monetary compensation does not include items of little value distributed by the firm.

Paragraph (ii) of new Rule 17a-3(a)(19) \53\ requires that firms maintain a record of all agreements pertaining to the relationship between each associated person and the broker-dealer, including a summary of each associated person's compensation arrangement or plan. Further, to the extent that compensation is based on factors other than remuneration on a per trade basis, the firm must make a record that describes the method by which compensation is to be determined.

\53\ This Rule was reproposed as Rule 17a-3(a)(12)(ii) and Rule 17a-3(a)(12)(iii).

It should be noted that the requirement under paragraph (ii) that a broker-dealer maintain a record of all agreements between itself and each associated person includes verbal agreements and records, such as commission schedules, which may change on a periodic basis.

The term ``relationship,'' as used in paragraph (a)(19) of Rule 17a-3, solely refers to the employment or contractual relationship between the associated person and the broker-dealer. It would not relate to personal relationships unrelated to the firm's business.

F. Compliance With Requirements for Communications With the Public

New paragraph (a)(20) of Rule 17a-3 \54\ requires each firm to make a record documenting that the firm has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal regulations and SRO rules which require that a principal approve any advertisements, sales literature, or other communications with the public.\55\ This paragraph would apply to marketing materials, sales scripts, and other paper or electronic material, such as audio or video tapes, used by broker-dealers in communicating with the public. This paragraph, which is designed to allow State Securities Regulators to examine broker-dealers for compliance with SRO rules relating to communications with the public,

does not establish a new source of supervisory responsibility. In addition, a broker-dealer has many options as to how it may create this record.\56\

\54\ This paragraph was reproposed as paragraph (a)(19) of Rule 17a-3.

\55\ See e.g., NASD Rule 2210(b) and NYSE Rule 472.

\56\ E.g., the record may consist of a principal's signature or initials on the communication, or a signed memo from the principal granting permission for use of the communication. Further, a firm may have policies and procedures designed to establish compliance with applicable federal regulations and SRO rules which require that a principal approve any advertisements, sales literature, or other communications with the public. Thus, records presently used to evidence compliance with SRO rules may also be used to fulfill this requirement.

The Commission did not adopt the portion of this rule as reproposed that referenced specific types of advertisements or sales literature. Instead, the Commission will defer to SRO rules as to which communications with the public must be approved by a principal of the firm.

G. Persons To Explain Records and Their Content

Paragraph (a)(21) of Rule 17a-3 requires a record listing, by name or title, all personnel at an office who, without delay, can explain the types of records the firm maintains at that office, and the information contained in those records. Commenters, particularly the States, indicated that this requirement is important because recordkeeping practices typically vary from firm to firm in ways ranging from format and presentation to the name of a record. Therefore, each firm must be able to promptly explain how it makes, keeps, and titles its records. To comply with this rule, a firm may identify more than one person and list which records each person is able to explain.

Because it may be burdensome for firms to keep this record current if it lists each person by name, a firm may satisfy this requirement by recording the

persons capable of explaining the firm's records by either name or title.

H. Record Listing Principals of the Firm

New paragraph (a)(22) of Rule 17a-3 requires firms to make a record listing each principal of the firm responsible for establishing policies and procedures reasonably designed to ensure compliance with any applicable securities regulatory authority requirements that require acceptance or approval of a record by a principal. This requirement is unchanged from the reproposal, and is intended to assist

securities regulators by identifying individuals responsible for designing a broker-dealer's compliance procedures and managing the firm.

I. Definition of Principal

Paragraph 17a-3(g)(2) defines the term ``principal'' to include any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer, or any other person who has been delegated supervisory responsibility for the firm or its associated persons. By including any person who has been delegated supervisory responsibility in the definition of the term ``principal,'' the rule has been modified from the reproposal to include the definitions of ``principal'' used by other securities regulatory authorities.

J. Definition of Securities Regulatory Authority

The definition of ``securities regulatory authority'' in paragraph (g)(3) of Rule 17a-3 is substantially similar to that in the Reproposing Release, except that State Securities Regulators are identified as ``the securities commissions (or any agency or office performing like functions) of the States * * *'' \57\ mirroring the language that Congress used in NSMIA.

\57\ Supra note 7.

K. Miscellaneous

The Commission has not adopted reproposed paragraph (a)(20) of Rule 17a-3, which would have required firms to make a record as to each associated person listing chronologically all customer purchase or sale transactions for which the associated person entered the order or was primarily responsible. Commenters stated that the information required in this record would already be maintained in other records, although not necessarily in the chronological format that this paragraph would have required. The Commission also has not adopted reproposed paragraph (a)(23) of Rule 17a-3, which would have required a firm to make a record listing each office of the firm and whether that office had been designated as a State record depository, since firms need no longer designate a State record depository for any purpose. This proposed record also would have required firms to list each associated person working out of or storing records at each office. The Commission has not adopted this requirement because firms are required to make a record of similar information under new paragraph (ii) of Rule 17a-3(a)(12).\58\

\58\ New paragraph (a)(12)(ii) of Rule 17a-3 requires firms to make a record showing, for each associated person, every office where the associated person regularly conducts a securities business and certain other information.

IV. Office Records

The Reproposing Release would have required that broker-dealers make certain records for each local office and maintain copies of those records at the office to which the records relate. These requirements were designed to assist securities regulators when conducting sales practice examinations at particular offices. The Commission has adopted the requirements regarding the creation of these records substantially as reproposed, but has materially altered the alternatives for maintenance of those records.

Generally, State Securities Regulators supported a requirement that records as to a particular office be maintained at that office, even if only electronically. The State Securities Regulators stated, in their comment letters, that they had encountered excessive and costly delays when conducting examinations when records were kept at another office. In sum, they stated that although firms generally had the records available in local offices, the firms preferred to funnel all records requested by examiners through their centralized compliance departments in order to assure accuracy, anticipate any potential violations, review material for applicable privileges, and make a record of documents reviewed by regulators.\59\ While the State regulators have the power to impose fines and penalties on firms that fail to timely produce records, the delays still result in unnecessary, wasted examination time at firms waiting for the records production. The delay is costly for regulators, particularly when they travel to remote areas to conduct surprise examinations at an office where they may spend numerous days awaiting the records.\60\

\59\ See Comment Letter from Citicorp, p. 3, ``RRs in all local offices would have to be trained to do a function outside their current job responsibilities, namely to review material for applicable privileges and make records of documents reviewed by regulators.''

\60\ See, e.g., Comment Letters from Arkansas Securities Department, pp. 1-3; Department of Financial Institutions, Commonwealth of Kentucky, p. 6; and Securities Division, State of Rhode Island and Providence Plantations, p. 1.

The broker-dealer commenters were strongly opposed to this requirement for two main reasons. First, they stated that the requirement to maintain copies of documents at all local offices would be costly and burdensome because they would need to create and maintain two sets of records. They stated that even with the flexibility of being able to maintain the records electronically, this requirement would be costly because many firms do not currently have computer systems capable of retaining and producing all the required records. Second, firms stated that maintaining records at all local offices would force them to decentralize their recordkeeping, which would potentially compromise their controls on recordkeeping and supervisory practices.

Requiring records to be maintained at each local office was the requirement most seriously disputed by the firms. The reproposal has been altered to allow a firm, rather than to maintain records at an office, to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which the records relate or at such other place as is agreed to by the representative. These alternative methods for complying with paragraph (k) of Rule 17a-4 were added in response to comments that the requirement, as reproposed, would have forced firms to decentralize their recordkeeping systems and would have compromised their internal controls and supervisory practices.\61\

\61\ This does not relieve broker-dealers from any other Federal or SRO requirements to maintain records at office locations. See, e.g., NASD Rule 3110(d) which requires firms to keep at each Office of Supervisory Jurisdiction (defined at NASD Rule 3010(g)(1)), either a separate file of all written complaints of customers and action taken by the firm, or a separate record of such complaints and a clear reference to the files containing the correspondence connected with such complaint maintained in such office.

The Commission believes that the amendments to Rules 17a-3 and 17a-4 adopted today, which set forth, (i) the definition of ``office,'' (ii) what records must be created as to each office,\62\ and (iii) what records must be maintained at each office,\63\ address the concerns of both regulators and broker-dealers.

\62\ 17 CFR 240.17a-3(f).
\63\ 17 CFR 240.17a-4(k).

[[**Page** 55825]]

A. Definition of Office

For both creation and maintenance of records, the definition of ``office'' adopted by the Commission includes any location where an associated person regularly conducts business.\64\ However, an office would not include a customer's office that an associated person may visit on a regular basis.

\64\ 17 CFR 240.17a-3(g)(1).

The Commission has also addressed concerns that arise when an associated person's residence is an office. Rule 17a-4(k) states that a

broker-dealer is not required to produce records at an office that is a private residence, provided that (i) only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family,\65\ regularly conduct business at the office; (ii) the office is not held out to the public as an office; and (iii) neither customer funds nor securities are handled at that office. Instead, Rule 17a-4(k) allows a broker-dealer to either maintain those records at some other location within the same State as that office as the broker-dealer chooses, or to promptly produce those records at an agreed upon location.

\65\ The term ``immediate family,'' as used in paragraph (k), should be interpreted to have the same meaning as it does in NASD IM-2110-1(l)(2).

For purposes of paragraph (f) of Rule 17a-3 \66\ and paragraph (k) of Rule 17a-4,\67\ in circumstances where an associated person works out of multiple offices, such as bank circuit riders, a firm may treat all the locations where the associated person regularly works as a single office.\68\

\66\ New paragraph (f) of Rule 17a-3 requires firms to make and keep current separately as to each office, the books and records required under various paragraphs in Rule 17a-3.

\67\ New paragraph (k) of Rule 17a-4 requires firms to either keep certain records at each office or produce them at that office or at another agreeable location.

\68\ Firms need not apply to or notify securities regulators as to which office it selects as the associated person's ``office.'' However, pursuant to paragraph (a)(12)(iii) of Rule 17a-3, the firm must identify the office as such.

B. Records ``As To'' Each Office

New paragraph (f) of Rule 17a-3 requires firms to make and keep current, separately for each office, certain books and records that reflect the activities of the office.\69\ It should be noted that 75% of broker-dealers have reported that they have no branch locations.\70\ The definition of ``office'' may be broader and more inclusive than the definition of ``branch,'' however.

\69\ The specific paragraphs of Rule 17a-3 that are included in this requirement are (a)(1), (a)(6), (a)(7), (a)(12), (a)(16), (a)(17), (a)(18), (a)(19), (a)(20), (a)(21), and (a)(22).

\70\ Per Schedule 1 data filed by broker-dealers as of year-ending December 31, 1998. Pursuant to 17 CFR 240.17a-10, Broker-dealers are required to file Schedule 1, which requires the

reporting of general information designed to measure certain economic and financial characteristics.

The Commission removed the sentence, ``This requirement may be satisfied by demonstrating that the data is maintained in a system which is capable of promptly generating records for each office upon request'', because the requirement to either maintain the specified records at each location or produce them on the same day a request is made has been changed to allow firms to produce these records promptly.

C. Records To Be Maintained at Office Locations

There have been two major changes to new paragraph (k) of Rule 17a-4 from the reproposal. First, the requirement to maintain certain records at the office locations has been expanded from one year to two years. This was done to establish parity with the retention requirements for the separate sections as provided under paragraph (b) of Rule 17a-4.

Second, under paragraph (k) of Rule 17a-4, if a broker-dealer does not maintain records at an office, but instead chooses to produce the records upon request, the broker-dealer must produce the records ``promptly.''\71\ The word ``promptly'' has deliberately not been defined in the rule. Generally, requests for records which are readily available at the office (either on-site or electronically) should be filled on the day the request is made. If a request is unusually large or complex, then the firm should discuss with the regulator a mutually agreeable time-frame for production.\72\

\71\ Supra note.

\72\ Valid reasons for delays in producing the requested records do not include the need to send the records to the firm's compliance office for review prior to providing the records.

Based on the foregoing, the Commission has not adopted the reproposed provision of Rule 17a-4(k) that would have allowed firms to maintain records at a State records depository in lieu of maintaining the records at the office to which the records relate.

One commenter requested guidance on how this paragraph relates to a foreign office of a U.S. registered broker-dealer.\73\ Under paragraph (f) of Rule17a-3, a broker-dealer must make certain records for a foreign office; however, a broker-dealer is not required to maintain or produce those records at the foreign office under paragraph (k). Instead, those records would be maintained at the broker-dealer's main office.

\73\ See Comment Letter from A.G. Edwards & Sons, Inc., p. 8.

V. Rule 17a-4

A. General Record Retention Requirements

Paragraphs (a) and (b)(1) of Rule 17a-4 list certain records required under Rule 17a-3 that must be kept for six and three years, respectively. The amendments to these two paragraphs have been modified from the reproposal to remain consistent with the modifications to Rule 17a-3.

B. Retention of Communications

Paragraph (b)(4) of Rule 17a-4 previously required that each broker-dealer keep originals of all communications received and copies of all communications sent by the firm relating to its business as a broker-dealer, including inter-office memoranda and communications. With respect to memoranda, including e-mail messages, the Commission has stated that the content and audience of the message determine whether a copy must be preserved, regardless of whether the message was sent on paper or sent electronically.\74\ The amendments to this paragraph adopted today will require firms to retain communications that are subject to SRO rules regarding ``communications with the public'' (such as advertising) as well, a requirement reproposed separately as paragraph (b)(10) of Rule 17a-4. This requirement is designed to provide State Securities Regulators with the ability to access these public communications records so they can enforce their laws relating to the form and use of public communications.

\74\ Exchange Act Release No. 38245 (Jan. 31, 1997), 62 FR 6469 (Feb. 12, 1997).

It should be noted that a written advertisement that is never released to the public would not be covered by this rule; however, a sales script that is used by an associated person when communicating with the public would be covered even if the script itself is not delivered to the public.

The requirement, as reproposed, that ``any written procedures [a broker-dealer] uses for reviewing the communications received or sent'' has been moved to new paragraph (e)(7) of Rule 17a-4, which requires firms to keep all compliance, supervisory, and procedures manuals, including any written procedures for reviewing communications.

C. Organizational Documents

The Commission has modified paragraph (d) of Rule 17a-4, which require a broker-dealer to maintain certain organizational records. Specifically, the Commission has added language to clarify that organizational records of legal entities not specifically delineated in the present rule \75\ are still required to be preserved under this rule. Various State statutes use different terms to describe the legal entities that may be created under their rules and the organizational

documents necessary to create those entities; accordingly, the Commission has included in this paragraph generic terms to describe the types of records that firms must keep. The Commission believes that generally broker-dealers that are not formed as corporations or partnerships are already keeping these types of records and that this amendment codifies current business practices. Similar to the amendment to paragraph (g)(3) of Rule 17a-3 noted above, the Commission has replaced the phrase ``state securities jurisdictions and self-regulatory organizations'' in the Reproposing Release with the term ``securities regulatory authorities.''

\75\ For instance, limited liability companies (``LLCs'') would be covered.

Under this paragraph, every broker-dealer is also required to maintain copies of its Form BD and all amendments thereto. To comply with this requirement with respect to amendments to Form BD, a broker-dealer is required to retain a copy of only those portions of the Form that were amended. The Commission believes that generally broker-dealers are already keeping these records and that this amendment codifies current business practices.

D. Account Record Information

New paragraph (e)(5) of Rule 17a-4 requires broker-dealers to retain account record information for six years. The six-year period begins either at the time the account is closed or when the information is replaced or updated. This provision will allow regulators to review account record information for at least the six years immediately prior to the examination or investigation. Broker-dealers generally maintain account record information for at least the life of the account to facilitate a number of business purposes, including suitability determinations and supervision of accounts and representatives.

E. Special Reports

New paragraph (e)(6) of Rule 17a-4 requires a firm to keep for three years a copy of all reports that a securities regulatory authority has requested or required a specific firm to create. Such special reports would include those reports that are requested or required under an order or settlement that requires the firm to produce the report as part of the terms of the order or settlement. The purpose of this paragraph is to clarify that these records must be kept and to provide guidance as to how long firms are expected to maintain these records.

This requirement is not designed to limit the ability of securities regulatory authorities to obtain records that are otherwise required to be created and maintained, such as records of internal communications required to be maintained under paragraph (b)(4) of Rule 17a-4.

F. Compliance, Supervisory and Procedure Manuals

The Commission is also adopting, as reproposed, new paragraph

(e)(7) of Rule 17a-4. This paragraph requires firms to retain a copy of all compliance, supervisory, and procedures manuals describing the firm's policies and practices with respect to compliance and supervision, as currently in use and for three years after the termination of the use of each manual, including any updates, modifications, and revisions to the manuals. This will ensure that securities regulators are able to obtain information as to what policies and procedures were in place at a given time.

G. Exception Reports

New paragraph (e)(8)(ii) of Rule 17a-4 requires firms to maintain copies of reports produced to review for unusual activity in customer accounts (commonly referred to as ``exception reports''). This paragraph does not obligate broker-dealers to create exception reports. Exception reports would include reports that identify exceptional numerical occurrences, such as frequent trading in customer accounts, unusually high commissions, or an unusually high number of trade corrections or cancelled transactions. These reports will help securities regulators discover sales practice problems such as churning, unauthorized trading, or other indications of micro-cap fraud, and will also provide securities regulators with information as to what type of data may have been available to the broker-dealer.

In lieu of retaining copies of the reports, a member, broker or dealer may choose to promptly re-create the reports upon request by a securities regulatory authority. If the broker-dealer elects to re-create exception reports instead of maintaining a copy of the report, but the firm has changed its systems so that it cannot re-create the same report, the broker-dealer may provide a copy of the report in the format presently available using historical data,\76\ but must also provide a record explaining each system change that affected each report.\77\ Lastly, if the firm is unable to re-create the report in any format for the most recent 18 months, due to changes, for example, in a database, software, or physical system, the rule provides that the broker-dealer may instead provide a record of the parameters that were used to generate the report for the time period specified by the representative of the securities regulatory authority. The Commission provided these alternatives in order to make this rule less burdensome on broker-dealers.

\76\ For example, if the original report includes customer name, account number, social security number, and transactional information, however the report that can be re-created at a later date does not include social security numbers, the firm should provide the re-created report to the regulator with an explanation that although social security numbers appeared on the original report, the firm is unable to re-create the report including that information.

\77\ This includes changes to hardware, software, or changes to the database used to produce the exception reports.

Many firms commented that this requirement would be potentially counter-productive because, if firms are required to retain copies of

all reports that they create, they would create fewer reports. However, the Commission believes that broker-dealers will continue to create those exception reports that are necessary to adequately supervise their business, and that retaining these reports will increase the efficiency of examinations by regulators and may reduce the examination burden on broker-dealers.

VI. Effective Date

The final rules adopted today shall become effective May 2, 2003.

VII. Technical Amendments

A. Electronic Storage Media

On February 5, 1997, the Commission amended Rule 17a-4 to allow broker-dealers to employ, under certain conditions, electronic storage media to maintain its records.\78\ The Commission proposed and is now adopting technical amendments to that rule.\79\ The

[[**Page** 55827]]

Electronic Storage Media Release requires a broker-dealer that employs micrographic or electronic storage media to be ready at all times to immediately provide a facsimile enlargement upon request by the Commission or its representatives.\80\ It also requires a broker-dealer that exclusively uses electronic storage media to fulfill some or all of its record preservation requirements to contract with a third party download provider that will file undertakings with the broker-dealer's designated examining authority indicating that the download provider will furnish promptly to the Commission, its designees or representatives, the information necessary to download information kept on the broker-dealer's electronic storage media.\81\ Because SROs and State Securities Regulators are neither representatives nor designees of the Commission but, to the extent that they have jurisdiction over the broker-dealer serviced by the third party download provider, are organizations that should have access to facsimile enlargements and download information, the Commission is adopting these technical amendments to provide them with access to these records. The Commission is also adopting these technical amendments so that when broker-dealers use the undertaking option under Regulation ATS, SROs and State Securities Regulators will have access to those records.\82\

\78\ Exchange Act Release No. 38245 (Feb. 5, 1997), 62 FR 6469 (Feb. 12, 1997) (``Electronic Storage Media Release'').

\79\ 17 CFR 240.17a-4(f).

\80\ See 17 CFR 240.17a-4(f)(3)(i).

\81\ See 17 CFR 240.17a-4(f)(3)(vii).

\82\ Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998).

B. Other Technical Amendments

The Commission is adopting amendments to Rule 17a-3(a)(12)(i) to update the list of stock exchanges for which an associated person's application for registration or approval may be used to satisfy the requirements under that paragraph. This amendment is a codification of current practices. The Commission is also adopting amendments to the language throughout Rules 17a-3 and 17a-4 that eliminate masculine references, and replace them with gender neutral references.

VIII. Costs and Benefits of the Amendments

In the Reproposing Release, the Commission requested comment on the costs and benefits associated with the reproposed rules and rule amendments.\83\ Of the comments received by the Commission, fifty-seven commenters discussed the benefits and costs associated with the reproposal. Of those commenters, thirty were broker-dealers,\84\ twenty-two were States,\85\ two were consumer groups,\86\ two were other groups,\87\ and one was an individual.\88\ Most of the commenters (including all of the broker-dealer commenters) argued that the costs outweighed the benefits of the reproposed amendments and that the cost estimates provided in the Reproposing Release were too low. Although most of those arguments were general in nature, twenty-three commenters specifically referenced paragraph (a)(17)(i) of Rule 17a-3,\89\ and fifteen commenters specifically referenced paragraph (k) of Rule 17a-4.\90\ All the States and the consumer groups that commented argued that most broker-dealers presently maintained most, if not all, the records required under the reproposed amendments, and that the benefits, although difficult to quantify, justified any costs which might be incurred.

\83\ See supra note 9, at p. 54411.

\84\ See Comment Letters from Mutual Service Corporation, p. 6; Titan Value Equities Group, Inc., pp. 2 and 4; USAA, pp. 2 and 6; MetLife, p. 4; A.G. Edwards and Sons, Inc., p. 6; MONY, p. 4; Capital West, p. 2; Comerica Securities, p. 2; Nationwide Investment Services Corporation, p. 2; Edward Jones, pp. 1 and 3; Advest, p. 1; Salomon Smith Barney, pp. 1 to 2; NyLife Securities, pp. 6 to 7; HD Vest, p. 2; American Express Financial Advisors, pp. 2 to 5; First Union, pp. 3 to 4; Charles Schwab, pp. 3 to 4; MML Investors Services, Inc., pp. 2 to 4; National Planning Corporation, p. 1; Pumphrey Securities, p. 2; Citicorp Investment Services, pp. 2 to 3; Discount Brokers, pp. 4 to 5; M & T Securities, pp. 1 and 2; Donaldson, Lufkin & Jenrette, p. 6; Investment Management & Research, Inc., p. 4; John Hancock Distributors, Inc., pp. 3 to 4; Southwest Securities, p. 2; the Securities Industry Association, p. 10; Merrill Lynch, pp. 1, 6 to 7, and 11; and Raymond James, p. 5.

\85\ See Comment Letters from Michigan, pp. 1 to 2; Idaho, pp. 1 and 4; Kansas, pp. 1 to 2; Delaware, pp. 1 to 2; Colorado, p. 2; North Dakota, p. 1; Ohio, p. 1; Texas, pp. 1, 2 to 3, and 6; Hawaii, pp. 1 to 2; Rhode Island, pp. 1 to 2; New Hampshire, pp. 1 and 2; Nebraska, p. 1; Utah, pp. 1 and 3; NASAA, pp. 3 to 5 and 22; New York, pp. 1 and 3; Virginia, pp. 1 to 3; New Jersey, pp. 2 to 7; Washington, pp. 2 and 6; Arkansas, pp. 1, 3, and 5; New Mexico, p. 1; North Carolina, pp. 1 to 2; and Montana, pp. 1, and 3 to 5.

\86\ See Comment Letters from AARP, p. 2; and the Consumer Federation of America, pp. 2 to 3.

\87\ See Comment Letters from American Council of Life Insurance, pp. 12 to 13; and International Association of Financial Planning, p. 6.

\88\ See Comment Letter from Thomas Koutris, p. 1.

\89\ This paragraph provides that broker-dealers must obtain certain information relating to the accounts of natural customers, and that customer account records must be updated regularly.

\90\ In the reproposed rule this paragraph provided that certain records had to be maintained at the local office, or that they had to be produced at the local office to which they related on the same day a request for those records was made by a representative of a securities regulatory authority.

One commenter stated that well-organized firms are less likely to experience the potentially catastrophic losses that result from serious securities violations.\91\ Many State Securities Regulators indicated in their comment letters that their agencies generally found that firms with inadequate books and records were more likely to have other problems, such as inadequate supervisory systems and selling-away issues. According to the NASD's Office of Dispute Resolution, $126 million and $76 million were awarded by NASD arbitrators in 1999 and 2000 respectively in customer claimant cases, of which $48 million and $21 million respectively constituted punitive damages.\92\ The vast majority of claims filed for arbitration with the NASD's Office of Dispute Resolution during this time period related to sales practice issues. In addition, two industry participants estimated that they presently pay outside counsel approximately $50 million and $25 million respectively each year to deal with sales practice complaints.\93\

\91\ See Comment Letter from State of Virginia, pp. 1 to 3.

\92\ Per NASD Dispute Resolution, Inc. website: http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.nasdradr.com/statistics.asp.

\93\ It should be noted that these estimates do not include any internal compliance, operational, and/or legal costs incurred by these firms in dealing with these complaints.

Many States indicated that they believed the amendments would impose only minimal additional costs to broker-dealers because, in their experience, many broker-dealers already maintain the records required by the amendments in order to comply with SRO rules, State laws that applied prior to NSMIA, or simply to properly manage costs and supervise offices. Further, some States indicated that they believed that broker-dealers were exaggerating the potential costs of the reproposed amendments.\94\

\94\ See, e.g., Comment Letter from the State of New Jersey, p. 5.

In fact, the States of Connecticut \95\ and Florida \96\ conducted special reviews, in conjunction with their examination programs, to determine the extent to which broker-dealers already maintained the records required under the Reproposal at office locations. The State of Connecticut concluded that its review ``overwhelmingly indicate[d] that all the books and records that would be required by the re-proposed

rule proposal are, at the present time, being maintained in offices within Connecticut and similarly outside the state.'' Further, Connecticut stated, ``During this review process the records were immediately available for inspection upon request,'' and ``the types of records required by the reproposed rule would not be burdensome in that the firms retained substantially more records than required.'' Connecticut also stated, ``[t]he retention schedules listed in the firms' compliance [manuals] were consistent with the requirements under the reproposed rule.'' Florida stated, ``[t]he reviews indicated that based on records maintained most branch offices met or exceeded the records requirement for the [re-]proposed rule, and ``[a] vast majority of the branch offices maintained the records on-site for periods of at least 2 years (and in some cases up to 6 years).'' Further, Connecticut stated, ``[t]he firms' recordkeeping requirements did not vary from location to location or even state to state because they were required by the firms' own compliance manuals,'' and ``[i]n certain instances, the firms' compliance manuals indicated that these additional records were necessary to adequately supervise its branch operations.'' Similarly, Florida stated, ``[m]anagement of several firms visited reported that record creation and retention is a nationwide requirement; the same for all offices in all states, not specific to the state of Florida * * * [t]his information was verified by the firms' Operational/Supervisory Compliance Manuals.''

\95\ See Second Comment Letter from State of Connecticut. The State of Connecticut performed examinations of forty-nine office locations of twenty-three broker-dealers in five States. Seventeen of these offices had two or less associated persons working there. In addition, the State reviewed the most recent 100 examinations it had performed, and as well as investigatory materials from the prior two years wherein subpoenas were issued to obtain broker-dealer records.

\96\ See Second Comment Letter from NASAA. The State of Florida performed examinations on 19 broker-dealers.

A number of the States contend that investors are defrauded of millions and millions of dollars every year as a result of sales practice violations by broker-dealers.\97\ Further, Commission staff found through ``The Large Firm Project'' \98\ ``25% of the branch office examinations conducted in this project resulted in referrals for enforcement investigation and possible disciplinary action,'' and

``[t]he examinations also revealed that some branch office managers were not implementing firm procedures adequately,'' and recommended that ``the Commission should develop better means of identifying sales practice problems.'' \99\ The enhanced recordkeeping requirements would help make available critical information necessary for securities regulatory authorities to discover and take appropriate action for various securities violations, particularly sales practice violations. The cost to securities regulatory authorities to obtain the same information and evidence that otherwise would be available by these rules from other methods would be high. In addition, the possibility exists that government regulatory authorities would be unable to obtain certain information by any other means if the information is not required to be kept. Investigatory delays often lead to additional investor losses. The State of New Jersey contended that these delays could lead to an erosion of public confidence in the industry, which can be exacerbated by the public's belief that securities regulatory authorities lack the ability to properly oversee broker-dealers and enforce securities regulations.\100\ NASAA commented that lack of public confidence in the marketplace can lead to an inability of issuers to raise capital.\101\

\97\ Four States provided specific information regarding investor losses. Illinois indicated (in its Comment Letter, p. 2) that over the past 8 years, 29 enforcement cases were brought in which Illinois investors lost over $38.9 million dollars. Kansas indicated (in the attachment to its Comment Letter) that, with respect to cases they have brought over the past ten years, Kansas customers have lost over $6.4 million dollars. Ohio indicated (in its Comment Letter, p. 3) that in one particular case Ohio investors lost over $60 million dollars. Lastly, Connecticut indicated (in its Comment letter, p. 2) that, with respect to cases they have brought where the investors' relationship was established through small offices, Connecticut investors have lost over $12 million.

\98\ Report by the Division of Market Regulation and the Division of Enforcement, U.S. Securities and Exchange Commission, The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices (May 1994).

\99\ Id., at pp. 5 and 7.

\100\ See, Comment Letter from the State of New Jersey, p. 3.

\101\ See, Comment Letter from NASAA, pp. 7-8.

Most broker-dealer commenters indicated that two of the reproposed amendments would cause them to incur substantial additional costs. These two amendments were paragraph (k) of Rule 17a-4, which required that records be maintained at local offices or that firms produce those records at the local office on the same day a request for records was made by a regulator at that local office, and paragraph (a)(17)(i) of Rule 17a-3, which required that a broker-dealer provide customers with a copy of their account record at specified times. As a result of comments received in response to the Reproposing Release, the Commission substantially modified those two amendments as described above.

The only other paragraphs broker-dealers specifically identified as

resulting in increased costs were (a)(6) and (a)(7) of Rule 17a-3, which require that brokerage order tickets include the time of receipt, and that dealer order tickets include a notation of any modifications to an order. The Commission addressed some of these comments by modifying paragraph (a)(6) to provide an exemption for mutual fund and variable contract orders processed on a subscription-way basis. Further, for certain securities, the receipt time and notation of modification are already required under SRO rules.\102\ The only cost to firms resulting from these paragraphs relate to assuring that processes for recording this information will record the information for all orders that are not exempt and not just those orders covered by SRO rules.

\102\ E.g., the NASD's OATS rules, and NYSE rules 123 and 410A.

A few commenters attempted to provide alternative cost estimates for use in calculating the costs of the amendments. Some firms provided specific numbers, but provided no explanation as to the source of their estimates or their reason for believing that they would be more accurate than the Commission's estimates. In addition, certain costs are no longer relevant because the Commission substantially modified the amendments in response to comments. Accordingly, after consideration of all of the circumstances, the Commission has altered its cost estimates to reflect the fact that changes were made to the amendments in response to the comments received. Further, where the amendments were not altered significantly, the Commission has substantially increased estimates of costs that commenters argued were significantly underestimated.

The Commission estimates that the aggregate cost of these amendments will be approximately between $78.2 million and $84.3 million in the first year, and between $52.5 and $58.6 million per year thereafter (depending on what estimated postage cost is included in the calculations). Dollar costs relating to specific amendments are detailed below.

For purposes of this cost-benefit analysis, the amendments to Rules 17a-3 and 17a-4 are divided into three groups: (i) Those pertaining to the maintenance of office records and alternatives to these requirements; (ii) those pertaining to the periodic updating of customer information; and (iii) all other new requirements covered by the amendments.

A. Changes To Rule 17a-4, Including Maintenance of Office Records and Alternatives To These Requirements

As amended, Rule 17a-4 requires broker-dealers to maintain certain

records at each office. As discussed above, new Rule 17a-4(k) was modified from the reproposal to provide broker-dealers with the alternative of ``promptly'' producing certain records pertaining to a particular office at that office or at a mutually agreeable alternative location. This modification should significantly reduce the compliance

costs associated with the amendments.

The amendments standardize the amount of time broker-dealers must maintain certain records, and may thereby increase the amount of time these records are kept by certain firms. Broker-dealers generally maintain these records already to comply with Federal laws or regulations, SRO rules, or in the normal course of business. These records include, (i) information relating to the principals responsible for reviewing and updating policies and procedures, (ii) copies of Forms BD, BDW and amendments thereto, (iii) copies of compliance, supervisory, and procedures manuals, (iv) customer account records, (v) order ticket information, (vi) records relating to compensation of associated persons, (vii) evidence of compliance with SRO advertising and sales literature rules, (viii) exception reports, and (ix) specialized reports produced pursuant to an order or settlement.

The amendments will also standardize the type of records that must be kept by broker-dealers and the manner in which those records must be produced during examinations. Before NSMIA, States had various books and records requirements. Although these requirements were similar to Commission and SRO requirements, differences existed that broker-dealers had to track and comply with. As one commenter stated, ``the cost savings to industry of moving from compliance in the pre-NSMIA days with a variety of State laws to a new uniform should be equally substantial and should more than make up for any [additional] burden imposed by the [amendments].'' \103\ The uniformity provided by NSMIA and these amendments to Rules 17a-3 and 17a-4 should result in significant cost savings to broker-dealers that operate in multiple jurisdictions.

\103\ See, Comment Letter from the Consumer Federation of America, p. 3, note 4.

---

1. Benefits

The amendments should result in increased efficiency and effectiveness of broker-dealer examinations, especially with respect to small offices. Increasing the efficiency of examinations tends to decrease the costs incurred by both regulators, whose staff spends time conducting examinations, and broker-dealers, whose personnel may be inconvenienced for the period the examiners are present in their offices. One State estimated that the average cost for them to perform an office examination was $1,300 to $1,500 per day.\104\ Another State suggested that a local office with well organized records normally takes 2 to 3 days to complete, but that an office with incomplete records takes an additional 2 or more days.\105\ While average costs and time periods may vary from State to State, their operations tend to be similar and the Commission expects the amendments to reduce the time and costs of State securities examinations. This will also allow regulators to identify abusive practices earlier during inspections and perform more targeted examinations. In addition, broker-dealers should benefit by having their operations interrupted for shorter time periods. Costs of examinations may also be further reduced due to the uniformity of the recordkeeping provided by the amendments, because regulators and broker-dealers will know what records the firms should have on hand.

\104\ See Comment Letter from State of Michigan Department of Consumer & Industry Services, p. 1.

\105\ See Comment Letter from State of Texas' State Securities Board, pp. 2-3.

---

2. Costs

The amendments were drafted to permit flexible methods for the creation and maintenance of records in order to reduce the burdens on broker-dealers. This gives broker-dealers the flexibility to choose the least costly method to comply with the rules based upon their present processes and systems capabilities.

The Commission believes that the amendments to Rule 17a-4 will not impose significant cost burdens because, in order to comply with federal laws or regulations, SRO rules, or in the normal course of business, broker-dealers already maintain most of the records specified in the amended rule. Similarly, broker-dealers already are required to provide regulators with books and records on demand. The Commission estimates that the amendments to Rule 17a-4 could result in additional costs for some broker-dealers who do not presently maintain certain items for the prescribed periods of time or in a manner where they can be easily segregated by office. On average, the Commission estimates these additional costs incurred by each broker-dealer to ensure compliance with the amendments to Rule 17a-4 to be approximately $405.00 \106\ per year, resulting in an overall cost to the industry of about $2.9 million per year.\107\

Also, as mentioned previously, the State of Connecticut concluded in its study that, ``the types of records required by the re-proposed rule would not be burdensome in that the firms retained substantially more records than required.'' \108\

\106\ The Commission estimates that these amendments to Rule 17a-4 will take broker-dealers an additional four hours each per year. In the Reproposal the Commission estimated that these amendments would take an additional eight hours. Since the amendments being adopted today allow broker-dealers the option of not maintaining records at each office or producing records to the office to which they relate on the same day they are requested, the original estimate was reduced by one-half. The Commission believes that firms will have senior compliance personnel ensure compliance with these amended rules. According to the Securities Industry Association (``SIA'') Management and Professional Earnings 2000 report, Table 051, the hourly cost of a Compliance Manager + 35% overhead is $101.25. ($101.25 x 4)=approximately $405.00 for each respondent, per year.

\107\ ($405.00 per respondent x (7,217 broker-dealers)=approximately $2.9 million per year.

\108\ Supra at note 95 .

B. Periodic Updating of Customer Account Record Information

Paragraph (a)(17) of Rule 17a-3 requires broker-dealers to obtain additional account record information. Present federal and SRO rules require that firms obtain and maintain that same information in many circumstances,\109\ and many broker-dealers presently obtain and maintain this information as a prudent business practice to avoid disputes with customers, or for other business reasons.

\109\ 17 CFR 240.17a-3(a)(9), NASD Rules 2310(b), 3110(c) and IM-2860-2, and NYSE Rules 405, 407, 408, 410A, and 721.10.

The amendments also require that broker-dealers send account record information \110\ to customers for verification within thirty days of account opening and at least every thirty-six months thereafter \111\ and to require that broker-dealers provide customers with certain account record information when changes are made.\112\

[[Page 55830]]

Many broker-dealers already send customers notification of address changes,\113\ and some also send a copy of a customer's new account form to the customer when an account is opened.\114\ While there is presently no requirement to send a copy of the customer account record at least once every 36 months to verify the information, broker-dealers are required to keep their records current.\115\

\110\ Including customer name, address, telephone number, employment status, annual income, net worth, and the investment objectives for the account.

\111\ The Commission originally proposed that broker-dealers verify customer account information at least once each year (See Proposing Release), however this was modified and reproposed as once every thirty-six months in the Reproposal based upon comments received from broker-dealers who contended that it would be too costly to send account information to customers yearly.

\112\ Broker-dealers must furnish notification of a change in the name or address information to the customer's old address, and must furnish a copy of new account record information to the customer if some other information component is changed.

\113\ See e.g., Comment Letter from Raymond James Financial, Inc., p. 4.

\114\ See e.g., Comment Letter from Investment Management & Research, Inc., p. 4.

\115\ Supra note 1.

---

1. Benefits

The amendments should benefit broker-dealers by assuring that they have up-to-date information when making investment recommendations and

reviewing suitability of certain transactions or investment strategies. Further, both broker-dealers and their customers will benefit by assuring that there is mutual understanding of the customer's financial position and objectives for the account. Indeed, requiring broker-dealers to update customer account records may assist less well managed firms in better supervising their operations to identify potential problems before they lead to regulatory or legal exposure and monetary losses.

Moreover, the amendments have been modified to exempt corporate accounts, inactive accounts, and accounts not requiring a determination of suitability. These changes reduce the total number of accounts covered by the updating requirements by over 25,000,000.\116\

\116\ See infra note 117.

---

2. Costs

The requirement to send account record information to customers will cause firms to incur costs to update their processes, and, with respect to the individual mailings, will add preparation expenses and additional postage charges. Further, firms will incur additional costs to update account information when customers notify the firm that their account record information has changed. Because broker-dealer processes, systems capabilities, and customer bases vary so widely, it is difficult to provide an estimated cost with which all parties will agree; however, the Commission estimates that for each of the 23,500,000 accounts to which a copy of the account record must be sent each year,\117\ broker-dealers will spend an average of approximately 3.28 minutes \118\ (including time for processing and any updating) costing between $1.36 and $1.62 per piece,\119\ including postage. Thus the aggregate cost of Rule 17a-3(a)(17) is estimated to be between $32 million and $38.1 million (depending on what estimated postage cost is included in the calculations). In addition, the Commission estimates that all broker-dealers will, on average, incur a one-time cost of approximately $312.00 each \120\ to update their forms, resulting in an aggregate cost of approximately $2.25 million.

\117\ Broker-dealers reported, in their 12/31/00 Schedule 1 filings (required to be filed pursuant to 17 CFR 240.17a-10), that they maintained a total of 97,600,000 customer accounts. The Commission estimates that at least 27,100,000 of these accounts are excluded from the provisions of Rule 17a-3(a)(17) because they are either not accounts of natural persons, inactive, or accounts for which the broker-dealer does not have a suitability requirement (the Commission arrived at this number using estimates provided by the firms, in their comment letters and otherwise, as to how many of their accounts would fit into one or more of these categories. See Rule 17 CFR 240.17a-3(a)(17)(i)(D)). Accordingly, the total number of accounts which would need to be contacted for updating is 70,500,000 every three years. 70,500,000/3 = 23,500,000 per year.

\118\ Of the 23,500,000 accounts to which a copy of the account agreement must be sent each year, 22,975,000 (or 97%) of those

accounts are attributable to 70 large broker-dealers which maintain over 100,000 customer accounts. Based upon the comment letters and other communications, large broker-dealers are more automated and small broker-dealers have more manual processes. The estimated additional time to send out customer account information is 1\1/2\ minutes per account for large broker-dealers and 7 minutes per account for small broker-dealers. The estimated number of customers who will provide updated account record information is 4,700,000 (or 20% of customers to which notification is sent--this estimate is based on a comment letter sent by Merrill Lynch) (4,559,000 the 4,700,000 are estimated to be maintained at large broker-dealers). The estimated time to update these account records is 5 minutes per account record for large broker-dealers and 10 minutes per account for small broker-dealers, and the estimated time to send updated account record to customer to notify of change is 1\1/2\ minutes for large broker-dealers and 7 minutes for small broker-dealers. The estimated number of customers who will change their account record without being prompted by a mailing is 3,525,000 (3,419,250 of which are maintained at large broker-dealers), and the estimated time to send updated account record information to those customers is 1\1/2\ minutes per account for large broker-dealers and 7 minutes per account for small broker-dealers. Thus it would take approximately 2.25 minutes per account contacted each year to send account records (((22,795,000 x 1\1/2\) + (705,000 x 7)) + ((4,559,000 x 1\1/2\) + (141,000 x 7)) + ((3,419,250 x 1\1/2\) + (105,750 x 7)))/23,500,000 accounts contacted yearly. In addition, it would take approximately 1.03 minutes per account contacted each year to update the account records (((4,559,000 x 5) + (141,000 x 10))/23,500,000 accounts contacted yearly. In total, the Staff estimates that it would take 3.28 minutes per account contacted each year for processing and any updating.

\119\ The estimated total additional hours to provide customers with account record information is 880,369 hours ((((22,795,000 x 1\1/2\) + (705,000 x 7)) + ((4,559,000 x 1\1/2\) + (141,000 x 7)) + ((3,419,250 x 1\1/2\) + (105,750 x 7)))/60 minutes). The estimated total additional hours to update customers accounts is 403,417 hours (((4,559,000 x 5) + (141,000 x 10))/60 minutes in an hour). The hourly wage of the average person who would be providing customers with account record information is $22.70 per hour (per the SIA Report on Office Salaries In the Securities Industry 2000, Table 082 (Retail Sales Assistant, Registered) and including 35% in overhead charges). The hourly wage of the average person who would be updating account record information is $25.90 per hour (per the SIA Report on Office Salaries In the Securities Industry 2000, Table 086 (Data Entry Clerk, Senior) and including 35% in overhead charges). Thus the aggregate cost of these hours is about $30.4 million ((880,369 hours x $22.70) + (403,417 hours x $25.90)). The estimated additional cost of paper, printing, and postage to provide this information to customers is between $.05 and $.244 per record sent, or between $1.6 million and $7.7 million (($.05 or $.244) x (23,500,000 + 4,700,000 + 3,525,000)). Yielding a total cost per record sent of between $1.36 and $1.62 (($30.4 million + ($1.6 million or $7.7 million))/23,500,000 records sent per year).

\120\ It is estimated that it will take firms 2 hours each, on average, to update their forms to include information regarding the meaning of investment objective terms. The Commission believes that

firms will have an attorney perform this task. According to the SIA Management and Professional Earnings 2000 report, Tables 107 (Attorney) and 108 (Compliance Attorney), the hourly cost of an attorney + 35% overhead is $156.00 per hour. ($156.00 x 2) = approximately $312.00 per broker-dealer.

As described more fully below, the Commission estimates that large broker-dealers (broker-dealers having over 100,000 accounts) will, on average, incur startup costs and ongoing costs to purchase and maintain additional equipment and develop systems of $.31 per account and $.25 per account respectively. Based upon the comment letters,\121\ the Commission believes that the additional costs for smaller broker-dealers is included in the hourly burden costs delineated above.

\121\ One small broker-dealer stated, ``smaller firms lack the automation to do this type of action* * * without additional personnel,'' (See Comment Letter from Titan Value Equities Group, Inc., p. 2) another stated, ``[w]e do not have electronic account records,'' (See Comment Letter from Capital West Securities, Inc., p. 2) and another stated, ``for most firms [the] initial identification process would be manual'' and ``compiling the account record to send would require* * * pulling out a paper file for the account and making photo copies of the documents or pulling up the account on a computer system and printing out the required account information screens.'' (See Comment Letter from Comerica Securities, p. 2.) No smaller broker-dealer provided information regarding any increased equipment or systems development costs.

Two large broker-dealers estimated the start-up costs of purchasing equipment and modifying systems to range from $1,000,000 \122\ to $1,300,000.\123\ These two firms had a total of approximately 7,500,000 accounts which appeared to be subject

to the updating requirement. The start-up costs per account, based upon these figures, is approximately $0.31 (($1,000,000 + $1,300,000)/ 7,500,000 accounts). It is important to note that the firms' estimates were based upon the assumption that they would have to update all of their accounts. Since the amendments adopted today provide an exemption for corporate accounts, inactive accounts, and accounts for which no suitability determination must be made, the actual costs will probably be much lower. These two firms further estimate that ongoing costs for equipment and systems development would range from $300,000 \124\ to about $1,600,000 \125\ per year. The ongoing costs per account would be $0.25 per account (($300,000 + $1,600,000)/7,500,000 accounts). Therefore, the total additional start-up and ongoing costs to obtain equipment and develop systems for these two large firms would be $0.56 per account ($0.31 + $0.25).

\122\ See Comment Letter from Morgan Stanley Dean Witter, p. 4.

\123\ See Comment Letter from Merrill Lynch, p. 7 ($630,000 + $370,000 + $300,000).

\124\ See Comment Letter from Dean Witter, p. 4.

\125\ See Comment Letter from Merrill Lynch, p. 7. Merrill Lynch's estimate that they would spend $3.8 million for ongoing costs was reduced to account for the fact that the Commission has included costs to send account records to customers, costs to update customer account records, costs to send notification of updates to customers, and postage costs, which are included in Merrill's $3.8 million figure, elsewhere.

Of the 70,500,000 accounts, 68,385,000 (97%) belong to large broker-dealers that have more than 100,000 accounts, therefore the total start-up costs for large broker-dealers to purchase equipment and develop their systems is about $21.2 million (68,385,000 x $0.31). Similarly, the ongoing equipment and systems development costs for large broker-dealers would be about $17.1 million per year (68,385,000 x $0.25).

C. Other New Requirements Covered by the Amendments

Paragraphs (a)(12) and (a)(19) of Rule 17a-3 require broker-dealers to keep certain records regarding each associated person, including all agreements pertaining to the associated person's relationship with the broker-dealer and a summary of each associated person's compensation arrangement,\126\ a record delineating all identification numbers relating to each associated person,\127\ a record of the office at which each associated person regularly conducts business,\128\ and a record as to each associated person listing transactions for which that person will be compensated.\129\ The Commission believes that broker-dealers generally create and maintain these records already under prudent recordkeeping procedures.\130\ The list of transactions for which each associated person will be compensated can be created at the time of an examination.

\126\ 17 CFR 240.17a-3(a)(19)(ii).

\127\ 17 CFR 240.17a-3(a)(12)(ii).

\128\ 17 CFR 240.17a-3(a)(12)(iii).

\129\ 17 CFR 240.17a-3(a)(19)(i).

\130\ See supra text accompanying notes 95 and 96.

Paragraph (a)(18) of Rule 17a-3 requires broker-dealers to keep a record relating to written customer complaints and maintain a record of whether customers were provided with an address where they should direct complaints. Firms may, instead of creating a separate record of complaints, simply maintain a copy of each complaint, along with a record of the disposition of the complaint.

Paragraphs (a)(6) and (a)(7) of Rule 17a-3 have been amended to require that broker-dealers also record the identity of the associated

person responsible for an account and the identity of the person who accepted the order, and whether the order was entered pursuant to discretionary authority. In addition, the amendment to paragraph (a)(6) requires that firms record the time an order was received from a customer, and the amendments to paragraph (a)(7) require that firms make a record of any modifications to an order. Paragraph (a)(6) now contains an exception providing that, for transactions done on a ``subscription-way'' basis, where an application or subscription agreement is sent to the issuer in place of an order ticket, broker-dealers may keep the application or subscription agreement in place of the order ticket. In addition, SRO rules already require that firms record and maintain certain of this information,\131\ and firms, to assist in their supervision of the activities of their associated persons and to assure that commissions are properly paid, already record the identity of persons as required under the amendments.

\131\ See supra 102 note.

The amendments also require broker-dealers to make records indicating that they have complied with applicable regulations of certain securities regulatory authorities,\132\ listing persons who can explain the information in the broker-dealer's records,\133\ and listing principals who are responsible for establishing compliance policies and procedures.\134\ The Commission believes that these amendments will cause broker-dealers to incur only minimal additional costs. Firms presently maintain records to evidence compliance with SRO and other rules, they presently maintain lists of principals or branch managers responsible for supervising each of their offices under other SRO rules, and they maintain lists of associated persons operating out of each office location. Firms must, as part of their supervisory system, identify principals responsible for reviewing the firm's procedures and taking action to achieve compliance with applicable securities laws, regulations and rules.\135\

\132\ 17 CFR 240.17a-3(a)(17)(ii) and 17 CFR 240.17a-4(b)(4).
\133\ 17 CFR 240.17a-3(a)(21).
\134\ 17 CFR 240.17a-3(a)(22).
\135\ See e.g., NASD Rule 3010.

---

1. Benefits

The records required by these sections are either presently required under other federal laws or rules or SRO rules or currently maintained by many firms as a prudent business practice. These amendments codify current recordkeeping practices and make clear what records broker-dealers may be required to provide to State and other regulators. These records are expected to assist firms in better supervising their operations and identifying potential problems before they lead to regulatory or legal exposure and monetary losses.

2. Costs

The Commission has endeavored to codify present broker-dealer business practices in these amendments and has adjusted the amendments based upon comments received in response to the Proposal and Reproposal, as discussed above. Thus, these amendments are not expected to change market or industry behavior significantly. For example, firms are presently required to maintain copies of all communications under Exchange Act Rule 17a-4(b)(4), and certain SRO rules require that members maintain copies of all written complaints and a record of the actions taken by the broker-dealer with respect to each complaint.\136\ Therefore, the Commission believes that amending Rule 17a-3 to require this information will not cause broker-dealers to incur any additional costs. Similarly, the Commission does not believe that the amendments to Rules 17a-3(a)(6) and 17a-3(a)(7) will cause any additional cost.

\136\ See e.g., NASD Rule 3110(d), and for options complaints NASD Rule 2860(b)(17).

Nevertheless, broker-dealers may incur costs in assuring that their present practices comply with the amendments. For example, the Commission believes that the requirement to provide customers with an address where they can send complaints will cause firms to incur a one-time cost of approximately

$312.00 \137\ each, resulting in an aggregate cost of approximately $2.25 million. In addition, the Commission estimates that it will cost each firm an average of $50.83 per year to ensure compliance with paragraphs (a)(12) and (a)(19) of Rule 17a-3 (regarding associated person records),\138\ resulting in an aggregate cost of approximately $0.4 million per year. Finally, the Commission estimates that each firm will spend an average of approximately $16.88 per year to ensure compliance with other requirements,\139\ resulting in an aggregate cost of approximately $0.1 million per year.

\137\ The Commission estimates that it will take each broker-dealer, on average, two hours to update its forms to include the address to which complaints should be sent. This is a very conservative estimate, since it will probably take much less than 2 hours to write down the broker-dealer's address and where it should be placed on the form, but additional time was added to account for supervisory review. The Commission believes broker-dealers would have an attorney perform this task. According to the SIA Management and Professional Earnings 2000 report, Tables 107 (Attorney) and 108 (Compliance Attorney), the hourly cost of an attorney + 35% overhead is $156.00 per hour. ($156.00 x 2) = approximately $312.00 per broker-dealer.

\138\ The Commission estimated in its Reproposal that, on average, this requirement will obligate a broker-dealer to spend approximately 30 minutes each year to ensure that the records are in compliance with these amendments. The Commission received no

specific comments relating to this estimate. The Commission believes firms may have senior compliance personnel perform this task. According to the SIA Management and Professional Earnings 2000 report, Table 051, the hourly cost of a Compliance Manager + 35% overhead is $101.25. ($101.25 x \1/2\ hour) = approximately $50.63 per broker-dealer.

\139\ The Commission estimated in its Reproposal that it will take each firm 10 additional minutes each year to assure compliance with the amendments, and it received no specific comments relating to this estimate. The Commission believes that firms will have senior compliance personnel perform this task. According to the SIA Management and Professional Earnings 2000 report, Table 051, the hourly cost of a Compliance Manager + 35% overhead is $101.25. ($101.25 x 10 minutes/60 minutes in an hour) = approximately $16.88 per broker-dealer.

IX. Effects on Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act \140\ requires the Commission, in adopting Exchange Act rules, to consider the impact any such rule would have on competition and to not adopt a rule that would impose a burden on competition not necessary or appropriate in furthering the purposes of the Exchange Act. Section 3(f) of the Exchange Act \141\ provides that whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission has considered the amendments to Rules 17a-3 and 17a-4 in light of the standards in Sections 23(a)(2) and 3(f) of the Exchange Act.

\140\ 15 U.S.C. 78w(a)(2).

\141\ 15 U.S.C. 78c(f).

In the Reproposing Release, the Commission requested comment on the effect of the reproposed rule amendments on competition, efficiency, and capital formation.\142\ The Commission received 115 substantive comment letters\143\ in response to the Reproposal. Approximately 44% were from broker-dealers opposing particular amendments and approximately 37% were from State Securities Regulators supporting the amendments. Few commenters provided any information on how these amendments would affect competition, efficiency, or capital formation. One commenter argued that, ``[c]ompetition among broker-dealers is facilitated by the amendments to the [Books and Records Rules]'' because they ``[allow] firms to create and maintain records by alternative means * * *.'' \144\ Conversely, a few of commenters argued that; (i) the requirement to maintain records at local offices would place an unfair competitive burden upon smaller broker-dealers who do not have the resources to utilize imaging technology,\145\ and (ii) the amendments would have a disparate impact on non-traditionally organized broker-dealers with limited businesses.\146\ In addition, a number of

commenters, while not specifically addressing this issue, did argue that it would be duplicative to maintain records at a local office while also maintaining the same documents at a main office. In response to these concerns and others, the Commission has modified the amendments to allow firms the flexibility to promptly produce records at the offices to which they relate instead of maintaining those records at the offices,\147\ and has added exemptions in recognition of present business practices.\148\

\142\ *Supra note 9, at 54411.*

\143\ Of the 144 total ``comment letters'' on file, seventeen are memos by the staff of the Commission relating to meetings with various industry groups, and twelve simply request that the comment period be extended.

\144\ See, Comment Letter from NASAA, p. 7.

\145\ See, Comment Letters from Titan Value Equities Groups, Inc., p. 3; BenefitsCorp Equities, Inc., p. 2; and One Orchard Equities, Inc. p. 2.

\146\ See, Comment Letter from MML Investor Services, Inc., pp. 5 to 6.

\147\ Paragraph (k) of Rule 17a-4.

\148\ See paragraphs (a)(6)(ii) and (a)(17)(i)(D) of Rule 17a-3. In addition, paragraph (a)(17) of Rule 17a-3 was modified to limit the requirement to accounts with a natural person as the customer.

The Commission believes that any burden imposed by the amendments is justified by the enhanced investor protections described above. Further, as NASAA pointed out in its comment letter, when addressing Section 23(a) concerns, ``the [amendments] to Rules 17a-3 and 17a-4, pursuant to a directive by Congress, must also reflect the needs of the State Securities Regulators as well as federal regulators.''\149\ In addition, by improving examination capabilities of all securities regulatory authorities, the amendments should improve investor confidence in broker-dealer firms and help to maintain fair and orderly markets.

\149\ See Comment Letter from NASAA, p. 4.

Broker-dealers with larger customer bases would have correspondingly greater obligations under the amendments than smaller broker-dealers. Accordingly, any burden on competition should be slight, especially in light of the significant regulatory benefits discussed above.

X. Summary of Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis (``FRFA'') regarding the amendments to Rules 17a-3 and 17a-4 under the Exchange Act,\150\ which require broker-dealers to maintain certain additional records, specify

that certain books and records must be maintained at each office, and set forth the length of time these records must be kept, has been prepared in accordance with the provisions of the Regulatory Flexibility Act (5 U.S.C. 604).

\150\ 15 U.S.C. 78a et. seq., adopted on October 11, 1996.

A. Need for the Rules and Rule Amendments

As discussed more fully in the FRFA, these amendments are intended to provide the Commission, SROs, and State Securities Regulators with timely access to broker-dealers' books and records to conduct effective examinations, investigations and enforcement actions. NSMIA prohibits States from establishing books and records rules that differ from, or are in addition to, the Commission's rules, and provides that the Commission must consult periodically with the States concerning the adequacy of the Commission's books and records rules,\151\ particularly with regard to whether the Commission's rules satisfy State Securities Regulators' need to have

records readily accessible for their examinations.\152\

\151\ 15 U.S.C. 78o(h).
\152\ See supra note 8.

If these amendments are not adopted, the Commission believes that the Commission staff and State Securities Regulators will be hampered in their efforts to obtain documentation, because the books and records that broker-dealers maintain may not always be sufficient or in such order as to enable regulators to conduct thorough and effective examinations, investigations, and enforcement proceedings. The Commission further believes that a failure to re-establish certain customer protection safeguards present in the marketplace prior to the enactment of NSMIA would reduce the regulatory oversight of broker-dealers. In addition, the Commission believes that this may also reduce customer confidence in the marketplace, which would be detrimental to market integrity and capital formation.

B. Small Entities Subject to the Rule

It is expected that these amendments will affect the approximately 1,000 broker-dealers that fall within the category of ``small business'' \153\ (``Small Business Broker-Dealers''). The amendments would affect these Small Business' Broker-Dealers because they, like other broker-dealers, would have to create and maintain certain additional books and records and would have to provide access to specific books and records at each office. An OTC Derivatives Dealer

would not be considered a small entity because of the minimum net capital requirement.

\153\ Pursuant to 17 CFR 240.0-10, the term ``small business'' or ``small organization'' when used with reference to a broker or dealer means a broker or dealer that: (i) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date its audited financial statements for the prior fiscal year were prepared pursuant to 17 CFR 240.17-5(d) or, if not required to file such statements, a broker-dealer that had total net capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in 17 CFR 240.0-10. In addition, Exchange Act Release No. 40122 (June 24, 1998) 63 FR 35508 (June 30, 1998) recently amended standard that defines what it means to be ``affiliated'' with any person that is not a small business.

A summary of the Initial Regulatory Flexibility Analysis (``IRFA'') appeared in the Reproposing Release,\154\ where the Commission specifically requested comment with respect to the IRFA. In response to the Reproposing Release, the Commission received only one comment letter specifically concerning the IRFA.\155\ In addition, three other commenters addressed aspects of the reproposed rules and rule amendments that could potentially affect small businesses.\156\

\154\ See supra note 9.

\155\ See Comment Letter from American Council of Life Insurance, p. 16.

\156\ See Comment Letters from Titan Value Equities Group, Inc., pp. 2-3; Lawrence Lowman, p. 1; and John Hancock Distributors, Inc., p. 3.

The commenter that did specifically discuss the IRFA stated, ``The Initial Regulatory Flexibility Analysis does not give careful consideration to the economic impact on [broker-dealers that limit their business in certain ways\157\] of the new account cards, blotter records, and signatures of principals on account cards.'' However, the Commission has carefully considered the economic impact of these rules on various types of broker-dealers. Furthermore, the Commission notes that the commenter does not take into account the fact that, even with respect to broker-dealers that limit their business, existing NASD rules\158\ require that broker-dealers maintain certain customer account information, including the signature of a principal accepting the account, and that Rule 17a-3(a)(1) \159\ presently requires that broker-dealers retain blotter records. The Commission has amended new paragraph 17a-3(a)(17) to provide an exemption from obtaining certain information where broker-dealers have no Federal or SRO suitability

requirement and are therefore not otherwise required to obtain that information.

\157\ E.g., broker-dealers which only facilitate transactions in certain types of products or broker-dealers which do not make recommendations.

\158\ See e.g., NASD Rule 3110(c).

\159\ 17 CFR 240.17a-4(a)(1).

Of the three commenters that addressed aspects of the reproposed rules and rule amendments that could potentially affect small businesses, one stated, ``[t]he proposal to require blotters in local offices may cause an initial financial burden to firms which have * * * three or less broker offices.'' \160\ Another argued that the requirement to maintain records at local offices ``place[s] an unfair competitive burden on smaller broker-dealers who do not have the resources to image the required documents and place them upon a network that is available to both the firm's principal office and the local branch.'' \161\ While the amendments as reproposed would require that firms maintain certain records in each local office or produce those records within the same business day that they are requested, the amendments have been changed in order to give firms the flexibility to produce those records promptly when they are requested by a representative of a securities regulatory authority. This change significantly reduces the cost of the amendments for most firms. In addition, recognizing that broker-dealers may not be required to maintain those records under SRO rules or other regulations, the Commission has attempted to reduce the impact of these amendments on firms that engage in certain specialized types of businesses by changing the amendments to allow those broker-dealers to utilize records they presently create and maintain in compliance with SRO or other rules and prudent business practices.

\160\ See Comment Letter from Lawrence Lowman, p. 1.

\161\ See Comment Letter from Titan Value Equities, p. 3.

Another firm contended that the requirement to update account records is unduly burdensome on smaller firms because such firms lack the automation to perform that task quickly and without additional personnel.\162\ The Commission has attempted to make these amendments sufficiently flexible to accommodate different types of operational systems, and broker-dealers may choose the operational methods that best suit their business in order to comply with the amendments.

\162\ Id., p. 2.

Lastly, another firm disagreed with the Commission's statement in the Reproposing Release that, ``[l]arger broker-dealers would have correspondingly greater obligations under the amendments,'' \163\ stating, ``the `wire house' firms will be virtually unaffected by this proposal,'' because ``wire houses * * * have very few small offices.'' \164\ To the extent that Small Business Broker-Dealers service fewer customer accounts, employ fewer associated persons, and operate fewer offices than larger broker-dealers, they will be affected by the rule in proportion to their size.

\163\ See Comment Letter from John Hancock Distributors, Inc., p. 3.

\164\ Id.

C. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Most broker-dealers, including Small Business Broker-Dealers, already maintain many of the records specified in the amendments in the ordinary course of business. The Commission's intent has been to minimize the impact of the amendments on all broker-dealers by limiting, consistent with the objectives of the amendments, the number of instances in which broker-dealers would be obligated to create or

maintain records that they do not already maintain in the ordinary course of business. In addition, the amendments were designed to be sufficiently flexible to accommodate different types of recordkeeping systems, and broker-dealers may choose the format in which they wish to maintain those records.

D. Agency Action To Minimize Effect on Small Entities

As discussed further in the FRFA, the Commission has attempted to minimize the economic impact these amendments might have on broker-dealers, including Small Business Broker-Dealers, while still achieving the overall objective of assuring that regulators have the ability to perform effective examinations, including examinations for sales practice issues. In response to comments elicited by the Reproposing Release, many significant changes were made to the amendments to reduce the burdens associated with these amendments.

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. The Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities. The

Commission also considered whether these alternatives to the reproposed rules and rule amendments would accomplish the stated objectives of improving the effectiveness of the Commission's and State regulatory agencies' ability to perform investigations, examinations and enforcement actions.

The additional burdens placed on Small Business Broker-Dealers will vary depending upon the number of customer accounts at the firm, the number of associated persons employed by the firm, and the number of offices that the firm operates. Further, the rule provides substantial flexibility in the manner in which firms may comply with the amendments. Additionally, the Commission believes that obtaining essential information regarding the sales practices of all broker-dealers, including Small Business Broker-Dealers, is necessary to permit securities regulators to effectively oversee the securities markets and protect investors; therefore, the Commission does not believe that establishing differing compliance or reporting requirements for Small Business Broker-Dealers would be appropriate.

The Commission believes that the proposal could not be formulated differently for Small Business Broker-Dealers and still achieve the stated objectives. The Commission has considered Small Business Broker-Dealers in developing the amendments and has determined that all types of broker-dealers, including Small Business Broker-Dealers, engage in sales practice abuses; therefore, the Commission does not believe that further clarification, consolidation, or simplification of the proposed amendments would be appropriate. As stated previously, however, the Commission has made every effort to assure that, to the extent possible, the amendments require broker-dealers to maintain the same types of records required under other federal and SRO rules or that firms usually maintain as part of their present business practices, and has highlighted instances where records that broker-dealers presently maintain may serve to fulfill the requirements under these amendments.

The Commission does not believe that it would be appropriate to use performance standards, rather than design standards, with relation to these amendments. Because information must be collected and maintained in a uniform manner to be useful, design standards are necessary to achieve the objectives of the proposal. Any additional burden placed on broker-dealers by these amendments is dependent on the number of accounts serviced, the number of associated persons employed, and the number of offices operated. Thus, although the use of performance standards would be an inappropriate measure with relation to these amendments, the standards used do take into account the size of each firm. The Commission also notes that the recordkeeping requirements permit broker-dealers to keep records in different formats or systems as long as specified information can be sorted and produced upon request.

Lastly, customers may be exposed to fraud and sales practice violations by Small Business Broker-Dealers as well as other firms. Exempting Small Business Broker-Dealers from coverage of the rules, or any part thereof, would create a gap in industry oversight, where regulatory authorities may be unable to obtain documentation necessary to conduct comprehensive examinations of Small Business Broker-Dealers. Therefore, the Commission believes that it should not exempt Small Business Broker-Dealers from the requirements of the amendments.

The Commission believes that enacting the amendments in their present form is the best way to assure that regulators have the ability to perform effective examinations, including examinations for sales practice issues, and that no less burdensome alternatives are available

to accomplish the objectives of the amendments. As stated previously, after NSMIA, States were constrained from ``establishing books and records rules that differ from, or are in addition to the Commission's rules.'' \165\ The States play an integral role in achieving customer protection by performing examinations on broker-dealers within their jurisdiction and reviewing for sales practice violations. Without these amendments, the States may be unable to obtain those books and records necessary to conduct comprehensive examinations. Finally, the Commission believes that most Small Business Broker-Dealers currently maintain certain of the additional records specified in the amendments.

\165\ 15 U.S.C. 78o(h).

A copy of the FRFA may be obtained by contacting Bonnie L. Gauch, Attorney, United States Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1001.

XI. Paperwork Reduction Act

Certain provisions of the amendments contain ``collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.\166\ The Commission has submitted the amendments to the Office of Management and Budget (``OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under the title ``Books and Records Rule Amendments.'' The rules being amended contain currently approved collections of information under OMB control numbers 3235-0033 and 3235-0279 respectively. The collections and maintenance of information, and the reports made to the SEC and others that are required pursuant to Rules 17a-3 and 17a-4 are mandatory. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

\166\ 44 U.S.C. 3502 et seq.

A. Collection of Information Under the Amendments

As discussed previously in this release, the Books and Records Rule Amendments would require registered broker-dealers to maintain additional records with respect to purchase and sale documents, customer information, associated person information, customer complaints and certain other matters.

B. Proposed Use of Information

The information collected pursuant to the Books and Records Rule

Amendments would be used by the Commission, SROs, and other securities regulatory authorities for examinations, investigations, and enforcement proceedings regarding broker-dealers and associated persons. No governmental agency would regularly receive any of the information described above. Instead, the information would be stored by the registered broker-dealer and made available to the various securities regulatory authorities as required to facilitate examinations, investigations, and enforcement proceedings. To comply with the amendments that require broker-dealers to update customer account records at least once every 36 months, broker-dealers would have to furnish the customers with copies of their account records. This requirement and the estimated burden associated with it are discussed in detail below.

C. Respondents

The Books and Records Rule Amendments would apply to all of the approximately 7,217 active broker-dealers that are registered with the Commission.\167\

\167\ Of approximately 7,739 broker-dealers registered with the Commission, approximately 341 are not yet active because their registration is pending SRO approval and approximately 181 are inactive because they have ceased doing a securities business and have filed a Form BDW with the Commission. Of these 7,217 active, registered broker-dealers, three are registered OTC Derivatives Dealers. OTC Derivatives Dealers are a special class of broker-dealers that limit their business to dealer activities in eligible over-the-counter derivative instruments and that meet certain financial responsibility and other requirements.

D. Total Annual Reporting and Recordkeeping Burden

The hour burden of the Books and Records Rule Amendments is difficult to ascertain, because any additional burdens would vary widely due to differences in broker-dealer activity levels and current recordkeeping systems employed by the broker-dealers. Therefore, the estimates in this section are based on averages among the various types and sizes of broker-dealers. Recognizing that large broker-dealers maintaining over 100,000 customer accounts are generally more automated than small broker-dealers maintaining less than 100,000 customer accounts with relation to certain of the amendments, the Commission has attempted to provide for these differences in its calculations.

Most of the requirements of the Books and Records Rule Amendments involve collections of information that broker-dealers already maintain pursuant to prudent business practices or to comply with existing SRO regulations. While some of the comment letters argued that the Commission's estimates set forth in the Reproposing Release were low, few contained actual alternative cost estimates, and none contained estimates which could be applied generally to broker-dealer firms. The Commission has increased its estimation of the expected burden of the amendments where, in general, commenters felt that the estimates were too low, and has provided a more detailed explanation of its estimates

where it believes the amendments will impose little or no additional burden on broker-dealers. In addition, in response to the comments received relating to the Reproposing Release, the Commission modified its proposal and adopted amendments that reduce the amount of additional records that firms will be required to create and maintain.

1. Rule 17a-3

The amendments modify Rule 17a-3 by, among other things, requiring broker-dealers to send account information to customers for verification within 30 days of account opening and at least once every 36 months thereafter. As stated above, the total number of accounts that would need to be contacted for updating is 70,500,000.\168\ Approximately 70 of the 7,217 active, registered broker-dealers maintain over 100,000 accounts, and the remaining broker-dealers (7,147) maintain less than 100,000 accounts each. Of the 70,500,000 accounts which may be affected by these amendments, approximately 68,385,000 (or 97%) are maintained at these large broker-dealers, and 2,115,000 (or 3%) are maintained at broker-dealers with less than 100,000 accounts each.

\168\ Supra note 117.

The Commission estimates that, as their processes are more automated, it will take large broker-dealers an average of 1\1/2\ additional minutes per account every three years,\169\ thus requiring large broker-dealers to spend an additional 569,875 hours per year (68,385,000 account records/3 years x 1.5 minutes / 60 minutes) to send account information to customers. As small broker-dealers utilize processes which are more manual in nature,\170\ the Commission estimates that it will take small broker-dealers an average of 7 minutes per account \171\ every three years, thus requiring small broker-dealers to spend an additional 82,250 hours per year (2,115,000 account records/3 years x 7 minutes/60 minutes) to send account records to customers. Thus the total additional burden on the industry to send account records to customers is 652,125 hours.

\169\ The Commission, in its Reproposal, estimated that it would take broker-dealers 10 seconds to furnish the account record to customers. Because many commenters contended that this estimate was too low, the Commission raised its estimates.

\170\ Supra note 121.

\171\ See Comment Letter from Comerica Securities, p. 2.

The Commission estimates that approximately 20% \172\ of the customers from whom information is requested will update their account record resulting in 4,700,000 updated account records each year (70,500,000/3 years x 20%). The Commission estimates that it would take, on average, 5 minutes for large broker-dealers to update each account and 10 minutes \173\ for small broker-dealers to update each account, resulting in an additional burden of 403,417 hours per year

((4,559,000 account records x 5 minutes/60 minutes) + (141,000 account records x 10 minutes/60 minutes)). This estimate takes into account the amount of time it would take to receive the returned data and input any changes into the account record. While it is acknowledged that some customers will provide broker-dealers with changes to their account information outside of this update process, as those are changes broker-dealers must contend with in the present environment, the amendments create no additional burden in this regard. Broker-dealers presently maintain current account records in the ordinary course of their business because existing SRO rules require them to maintain current information about their customers.

\172\ See Comment Letter from Merrill Lynch, p. 7.
\173\ See Comment Letter from Titan Value Equities, Inc., p. 2.

If a customer has provided the broker-dealer with updated account record information, under paragraphs (a)(17)(i)(B) (2) and (3) of Rule 17a-3 the broker-dealer must send a copy of the revised account record to the customer within 30 days after it received notification of the change or, under paragraph (a)(17)(i)(B)(3), the broker-

dealer may send the notification with the next statement mailed to the customer. The Commission estimates that, in addition to the 70,500,000 updated account records discussed above, 3,525,000 customers (5% of the 70,500,000 accounts for which firms will be required to make the account record) will initiate changes to their account records on a yearly basis, just as they do now, with no prompting from any account record mailing. The Commission estimates, as stated above, that it will take large broker-dealers 1\1/2\ minutes and smaller broker-dealers 7 minutes to send out account information to each customer who updated their account. The Commission estimates that 8,225,000 (4,700,000 + 3,525,000) customers will update their account record, and that broker-dealers will spend an additional 228,244 hours each year ((7,978,250 account records x 1.5 minutes / 60 minutes) + (246,750 account records x 7 minutes / 60 minutes)) sending the updated account records to customers.

The amendments also impose a requirement that broker-dealers obtain the following additional information for each account with a natural person as the customer: the customer name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, investment objectives, and the signature of the associated person and a principal. Present Rule 17a-3(a)(9) already requires that a firm maintain a record of a customer's name and address. Further, SRO rules require that firms obtain and maintain records of: whether a customer is of legal age (firms usually obtain a customer's date of birth to satisfy this requirement), the signature of the registered representative and principal, a customer's tax identification number, the customer's occupation, and whether or not the customer is associated with another broker-dealer.\174\ In addition, certain SRO rules require that before making any recommendations to customers, broker-dealers obtain information,

regarding the customer's annual income, net worth, and the investment objectives for the account in question in order to formulate a basis for any recommendation.\175\

\174\ See NASD Rules 3110(c) and IM-2860-2, and NYSE Rules 405, 407, 410A, and 721.10.

\175\ See e.g., NASD Rule 2310(b) and IM-2860-2.

In addition, the amendments require that, if the account is a discretionary account, the firm must obtain (i) The signature of the customer granting discretion, (ii) the date discretion was granted, and (iii) the signature of the person to whom discretion was granted. Certain SRO rules require that for discretionary accounts, broker-dealers must obtain the signature of the person who was granted discretion, and the date discretion was granted,\176\ while other SRO rules require that firms obtain written authorization of the customer before exercising discretion in an account.\177\ Further, the Commission believes that obtaining these records is a prudent business practice followed by most broker-dealers to avoid disputes with customers.

\176\ Supra note 158.

\177\ See e.g., NYSE Rule 408.

In addition to the account record requirements, the amendments require broker-dealers to keep certain records regarding their associated persons, including all agreements pertaining to the associated persons relationship with the broker-dealer and a summary of each associated person's compensation arrangement,\178\ a record delineating all identification numbers relating to each associated person,\179\ a record of the office at which each associated person regularly conducts business,\180\ and a record as to each associated person listing transactions for which that person will be compensated.\181\ The Commission believes that broker-dealers generally create and maintain these records under prudent recordkeeping procedures. Therefore, the Commission estimates that, on average, these records would require each broker-dealer to spend approximately 30 minutes each year to ensure that it is in compliance with these amendments, a total of about 3,609 hours ((7,217 broker-dealers x 30 minutes/60 minutes).

\178\ Supra note 126.

\179\ Supra note 127.

\180\ Supra note 128.

\181\ Supra note 129.

The amendments also require broker-dealers to keep a record relating to written customer complaints that includes: the complainant's name, address, and account number; the date the complaint was received; the name of any associated person identified in the complaint; a description of the nature of the complaint; and, the disposition of the complaint. In order to account for differing broker-dealer practices, the Commission has provided broker-dealers with an alternative; instead of creating what may be a new record, broker-dealers can simply maintain a copy of each complaint, along with a record of the disposition of the complaint.\182\ Firms are presently required to maintain copies of all communications under Rule 17a-4(b)(4), and certain SRO rules require that members maintain copies of all written complaints and a record of the actions taken by the broker-dealer in specified offices, and that copies of options-related complaints be maintained in both the main office and in the branch office to which they relate.\183\ Most firms maintain copies of all complaints and related information and documents at their headquarters, and some already maintain both option and non-option complaints at all offices as well. While the Reproposal would have required that complaints relating to an office be maintained in that office or be produced on the business day they are requested, the amendments as adopted require only that records of complaints for an office be produced promptly at the office to which the complaints relate.

\182\ 17 CFR 240.17a-3(a)(18)(i).
\183\ Supra note 136.

The amendments also require broker-dealers to make records which indicate that they have complied with applicable regulations of certain securities regulatory authorities,\184\ which list persons who can explain the information in the broker-dealer's records,\185\ and that list principals responsible for establishing compliance policies and procedures.\186\ Firms presently maintain records to evidence compliance with SRO and other rules; therefore, no additional burden is created by this amendment. The Commission believes that broker-dealers presently maintain lists of principals or branch managers responsible for supervising each of their offices under applicable SRO rules, and that they also have lists of associated persons operating out of each office location. Under certain SRO rules, broker-dealers must presently have supervisory systems in place that include identification of principals responsible for reviewing the firm's procedures and taking action to achieve compliance with applicable securities laws, regulations and rules.\187\ The Commission estimates, therefore, that on average each broker-dealer would spend 10 minutes each year to ensure compliance with these requirements, yielding a total additional burden of about 1,203 hours ((7,217 broker-dealers x 10 minutes/60 minutes).

\184\ 17 CFR 240.17a-3(a)(17)(ii) and 17 CFR 240.17a-3(a)(20).
\185\ Supra note 133.

\186\ Supra note 134.
\187\ Supra note 135.

The amendments relating to order tickets require that broker-dealers note, in addition to information already required, the identity of the associated

person responsible for an account and the identity of the person who accepted the order, and whether the order was entered pursuant to discretionary authority. In addition, the amendments to Rule 17a-3(a)(6) require that firms record the time an order was received from a customer, and the amendments to Rule 17a-3(a)(7) require that firms make a record of any modifications to an order. SRO rules already require that firms record, maintain, and in some cases report, the time an order was received, and information regarding modification and cancellation including instructions and the time.\188\ Further, firms who assign associated persons to particular accounts usually refer the customer to that person to initiate transactions. The identity of the person who accepted the order from the customer, whether or not it was the person assigned to the account, is generally recorded and maintained at the present time by firms as a prudent business practice that assists the firm in properly supervising the activities of their associated persons and assuring that commissions are properly paid. In addition, the amendment to Rule 17a-3(a)(6) contains an exception for transactions done on a ``subscription-way'' basis, where an application or subscription agreement is sent to the issuer in place of an order ticket. For these types of transactions, broker-dealers may keep the application or subscription agreement in the place of the order ticket. Thus the Commission does not believe that the amendments to Rules 17a-3(a)(6) and 17a-3(a)(7) will cause any additional burden.

\188\ Supra note 102.

In total, the Commission estimates that compliance with the amendments to Rule 17a-3 will require an additional 1,288,598 hours (1,283,786 \189\ + 3,609 \190\ + 1,203 \191\).

\189\ 17 CFR 240.17a-3(a)(17).
\190\ 17 CFR 240.17a-3(12) and (19).
\191\ 17 CFR 240.17a-3(a)(20) to (22).

---

2. Rule 17a-4

The amendments modify Rule 17a-4 by requiring broker-dealers to maintain certain additional books and records, including a record listing all persons who are qualified to explain a broker-dealer's

books and records. The amendments also require broker-dealers to make available certain records at each office. As discussed above, new Rule 17a-4(k) was modified to provide that, instead of requiring that firms either maintain copies of records in the office to which they pertain, broker-dealers now have the option of producing certain records which relate to a particular office ``promptly.'' This significantly reduces the additional burden caused by the amendments to Rule 17a-4.

The amendments also increase the amount of time broker-dealers must maintain certain records. Broker-dealers generally maintain these records to comply with other federal or SRO Rules or in the normal course of business. These records include, (i) information relating to the principals responsible for reviewing and updating policies and procedures, (ii) copies of Forms BD, BDW and amendments thereto, (iii) copies of compliance, supervisory, and procedures manuals, (iv) customer account records, (v) order ticket information, (vi) records relating to compensation of associated persons, (vii) evidence of compliance with SRO advertising and sales literature rules, (viii) exception reports, and (ix) specialized reports produced pursuant to an order or settlement.

Based upon the information above, and due to the fact that the amendments to Rule 17a-4 require only that information be kept for prescribed periods of time, the Commission estimates that, on average, each broker-dealer would spend four hours each year to ensure that it is in compliance with the amendments to Rule 17a-4 and to produce required records promptly at an office when so required. Therefore, the Commission estimates that compliance with the amendments for Rule 17a-4 would require an additional 28,868 hours each year ((7,217 broker-dealers x 4 hours).

E. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to--(i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) Evaluate the accuracy of the agency's estimate of the burden of the proposed collections of information; (iii) Enhance the quality, utility, and clarity of the information to be collected; (iv) Minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. The Commission encourages commenters to identify and supply any relevant data, analysis and estimates concerning the burden of the proposed rules, especially where any commenter believes the Commission's estimates to be inaccurate.

Persons desiring to submit comments on the collection of information requirements proposed above should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503; and (2) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609 with reference to File No. S7-26-98. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collections of information to OMB

for approval. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-26-98, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

XII. Statutory Basis

The amendments are adopted pursuant to the authority conferred on the Commission by the Exchange Act, including Sections 17(a) and 23(a).

List of Subjects in 17 CFR Parts 240 and 242

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, Title 17 Chapter II of the Code of Federal Regulation is amended as follows:

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is amended by adding the following citation:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w);

* * * * *

2. The authority citations following Secs. 240.17a-3 and 240.17a-4 are removed.

3. Section 240.17a-3 is amended by:

a. Revising paragraphs (a)(6) and (a)(7);

b. Revising the introductory text of paragraph (a)(12)(i);

c. Revising paragraph (a)(12)(ii);

d. Redesignating paragraphs (a)(12)(i)(a) through (a)(12)(i)(h) as paragraphs (a)(12)(i)(A) through (a)(12)(i)(H); and

e. Adding paragraphs (a)(17), (a)(18), (a)(19), (a)(20), (a)(21), (a)(22), (f) and (g).

The revisions and additions read as follows:

Sec. 240.17a-3 Records to be made by certain exchange members, brokers

and dealers.

(a) * * *

(6)(i) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof; the account for which entered; the time the order was received; the time of entry; the price at which executed; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. The memorandum need not show the identity of any person, other than the associated person responsible for the account, who may have entered or accepted the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person; in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated. The term instruction shall include instructions between partners and employees of a member, broker or dealer. The term time of entry shall mean the time when the member, broker or dealer transmits the order or instruction for execution.

* * * * *

(ii) This memorandum need not be made as to a purchase, sale or redemption of a security on a subscription way basis directly from or to the issuer, if the member, broker or dealer maintains a copy of the customer's subscription agreement regarding a purchase, or a copy of any other document required by the issuer regarding a sale or redemption.

(7) A memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order and of any modification thereof; the account for which it was entered; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum need not show the identity of any person other than the associated person responsible for the account who may have entered the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person: in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order with a customer other than a member, broker or dealer entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated.

* * * * *

(12)(i) A questionnaire or application for employment executed by each ``associated person'' (as defined in paragraph (g)(4) of this section) of the member, broker or dealer, which questionnaire or application shall be approved in writing by an authorized representative of the member, broker or dealer and shall contain at least the following information with respect to the associated person:

* * * * *

(ii) A record listing every associated person of the member, broker or dealer which shows, for each associated person, every office of the member, broker or dealer where the associated person regularly conducts the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security for the member, broker or dealer, and the Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the member, broker or dealer.

* * * * *

(17) For each account with a natural person as a customer or owner:

(i)(A) An account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; however, financial information for the individual joint owners may be combined. The account record shall indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the member, broker or dealer. For accounts in existence on the effective date of this section, the member, broker or dealer must obtain this information within three years of the effective date of the section.

(B) A record indicating that:

(1) The member, broker or dealer has furnished to each customer or owner within three years of the effective date of this section, and to each customer or owner who opened an account after the effective date of this section within thirty days of the opening of the account, and thereafter at intervals no greater than thirty-six months, a copy of the account record or an alternate document with all information required by paragraph (a)(17)(i)(A) of this section. The member, broker or dealer may elect to send this notification with the next statement mailed to the customer or owner after the opening of the account. The member, broker or dealer may choose to exclude any tax identification number and date of birth from the account record or alternative document furnished to the customer or owner. The member, broker or dealer shall include with the account record or alternative document provided to each customer or owner an explanation of any terms regarding investment objectives. The account record or alternate document

furnished to the customer or owner shall include or be accompanied by prominent statements that the customer or owner should mark any corrections and return the account record or alternate document to the member, broker or dealer, and that the customer or owner should notify

the member, broker or dealer of any future changes to information contained in the account record.

(2) For each account record updated to reflect a change in the name or address of the customer or owner, the member, broker or dealer furnished a notification of that change to the customer's old address, or to each joint owner, and the associated person, if any, responsible for that account, on or before the 30th day after the date the member, broker or dealer received notice of the change.

(3) For each change in the account's investment objectives the member, broker or dealer has furnished to each customer or owner, and the associated person, if any, responsible for that account a copy of the updated customer account record or alternative document with all information required to be furnished by paragraph (a)(17)(i)(B)(1) of this section, on or before the 30th day after the date the member, broker or dealer received notice of any change, or, if the account was updated for some reason other than the firm receiving notice of a change, after the date the account record was updated. The member, broker or dealer may elect to send this notification with the next statement scheduled to be mailed to the customer or owner.

(C) For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record information required under paragraph (a)(17)(i)(A) of this section shall excuse the member, broker or dealer from obtaining that required information.

(D) The account record requirements in paragraph (a)(17)(i)(A) of this section shall only apply to accounts for which the member, broker or dealer is, or has within the past 36 months been, required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. Additionally, the furnishing requirement in paragraph (a)(17)(i)(B)(1) of this section shall not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. This paragraph (a)(17)(i)(D) does not relieve a member, broker or dealer from any obligation arising from the rules of a self-regulatory organization of which it is a member regarding the collection of information from a customer or owner.

(ii) If an account is a discretionary account, a record containing the dated signature of each customer or owner granting the authority and the dated signature of each natural person to whom discretionary authority was granted.

(iii) A record for each account indicating that each customer or owner was furnished with a copy of each written agreement entered into on or after the effective date of this paragraph pertaining to that account and that, if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement.

(18) A record:

(i) As to each associated person of each written customer complaint received by the member, broker or dealer concerning that associated person. The record shall include the complainant's name, address, and account number; the date the complaint was received; the name of any other associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. Instead of the record, a member, broker or dealer may maintain a copy of each original complaint in a separate file by the associated person named in the complaint along with a record of the disposition of the

complaint.

(ii) Indicating that each customer of the member, broker or dealer has been provided with a notice containing the address and telephone number of the department of the member, broker or dealer to which any complaints as to the account may be directed.

(19) A record:

(i) As to each associated person listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record shall include the amount of compensation if monetary and a description of the compensation if non-monetary. In lieu of making this record, a member, broker or dealer may elect to produce the required information promptly upon request of a representative of a securities regulatory authority.

(ii) Of all agreements pertaining to the relationship between each associated person and the member, broker or dealer including a summary of each associated person's compensation arrangement or plan with the member, broker or dealer, including commission and concession schedules and, to the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation is determined.

(20) A record, which need not be separate from the advertisements, sales literature, or communications, documenting that the member, broker or dealer has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal requirements and rules of a self-regulatory organization of which the member, broker or dealer is a member which require that advertisements, sales literature, or any other communications with the public by a member, broker or dealer or its associated persons be approved by a principal.

(21) A record for each office listing, by name or title, each person at that office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records.

(22) A record listing each principal of a member, broker or dealer responsible for establishing policies and procedures that are reasonably designed to ensure compliance with any applicable federal requirements or rules of a self-regulatory organization of which the member, broker or dealer is a member that require acceptance or approval of a record by a principal.

* * * * *

(f) Every member, broker or dealer shall make and keep current, as to each office, the books and records described in paragraphs (a)(1), (a)(6), (a)(7), (a)(12), (a)(17), (a)(18)(i), (a)(19), (a)(20), (a)(21), and (a)(22) of this section.

(g) When used in this section:

(1) The term office means any location where one or more associated persons regularly conduct the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security.

(2) The term principal means any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer or any other person who has been delegated supervisory responsibility over associated persons by the member, broker or dealer.

(3) The term securities regulatory authority means the Commission, any self-regulatory organization, or any securities commission (or any agency or office performing like functions) of the States.

(4) The term associated person means an ``associated person of a member'' or ``associated person of a broker or dealer'' as defined in sections 3(a)(21) and 3(a)(18) of the Act (15 U.S.C. 78c(a)(21) and (a)(18)) respectively, but shall not include persons whose functions are solely clerical or ministerial.

Sec. 240.17a-3 [Amended]

4. Section 240.17a-3 is amended by:

a. Removing from the introductory text of paragraph (a) and paragraph (a)(5) the word ``his'' and in its place adding ``it'';

b. Removing from paragraph (a)(11)(ii) the word ``he'' and in its place adding ``it'';

c. Removing from redesignated paragraphs (a)(12)(i)(A) and (a)(12)(i)(B) the word ``His'' and in its place adding ``The associated person's'';

d. Removing from redesignated paragraphs (a)(12)(i)(A), (a)(12)(i)(C), and (a)(12)(i)(H) the word ``his'' and in its place adding ``the associated person's'';

e. Removing from redesignated paragraphs (a)(12)(i)(D) and (a)(12)(i)(F) the word ``him'' and in its place adding ``the associated person'';

f. Removing from redesignated paragraphs (a)(12)(i)(D), (a)(12)(i)(E), (a)(12)(i)(F) and (a)(12)(i)(H) the word ``he'' and in its place adding ``the associated person'' and

g. Removing from redesignated paragraph (a)(12)(i)(H) the phrase ``or the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Coast Stock Exchange, or the Philadelphia-Baltimore Stock Exchange'' and in its place adding ``the American Stock Exchange LLC, the Boston Stock Exchange, Inc., the Chicago Stock Exchange, Inc., the New York Stock Exchange, Inc., the Pacific Exchange, Inc., the Philadelphia Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the Cincinnati Stock Exchange, Inc. or the International Securities Exchange''.

5. Section 240.17a-4 is amended by:

a. Revising paragraph (a);

b. Revising the introductory text of paragraph (b);

c. Revising paragraphs (b)(1), (b)(4), (c) and (d);

d. Revising the introductory text of paragraph (e);

e. Adding paragraphs (e)(5), (e)(6), (e)(7), (e)(8);

f. Revising paragraph (j); and

g. Adding paragraphs (k) and (l).

The revisions and additions read as follows:

Sec. 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

(a) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve for a period of not less than six years, the first two years in an easily accessible place, all records required to be made pursuant

to paragraphs Sec. 240.17a-3(a)(1), (a)(2), (a)(3), (a)(5), (a)(21), (a)(22), and analogous records created pursuant to paragraph Sec. 240.17a-3(f).

(b) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve for a period of not less than three years, the first two years in an easily accessible place:

(1) All records required to be made pursuant to Sec. 240.17a-3(a)(4), (a)(6), (a)(7), (a)(8), (a)(9), (a)(10), (a)(16), (a)(18), (a)(19), (a)(20), and analogous records created pursuant to Sec. 240.17a-3(f).

* * * * *

(4) Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public. As used in this paragraph (b)(4), the term communications includes sales scripts.

* * * * *

(c) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve for a period of not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account.

(d) Every member, broker and dealer subject to Sec. 240.17a-3 shall preserve during the life of the enterprise and of any successor enterprise all partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books (or, in the case of any other form of legal entity, all records such as articles of organization or formation, and minute books used for a purpose similar to those records required for corporations or partnerships), all Forms BD (Sec. 249.501 of this chapter), all Forms BDW (Sec. 249.501a of this chapter), all amendments to these forms, all licenses or other documentation showing the registration of the member, broker or dealer with any securities regulatory authority.

(e) Every member, broker and dealer subject to Sec. 240.17a-3 shall maintain and preserve in an easily accessible place:

* * * * *

(5) All account record information required pursuant to Sec. 240.17a-3(a)(17) until at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

(6) Each report which a securities regulatory authority has requested or required the member, broker or dealer to make and furnish to it pursuant to an order or settlement, and each securities regulatory authority examination report until three years after the date of the report.

(7) Each compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual, describing the policies and practices of the member, broker or dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the member, broker or dealer until three years after the termination of the use of the manual.

(8) All reports produced to review for unusual activity in customer

accounts until eighteen months after the date the report was generated. In lieu of maintaining the reports, a member, broker or dealer may produce promptly the reports upon request by a representative of a securities regulatory authority. If a report was generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced using historical data in the same format as it was originally generated, the report may be produced by using the historical data in the current system, but must be accompanied by a record explaining each system change which affected the reports. If a report is generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced in any format using historical data, the member, broker or dealer shall promptly produce upon request a record of the parameters that were used to generate the report at the time specified by a representative of a securities regulatory authority, including a record of the frequency with which the reports were generated.

* * * * *

(j) Every member, broker and dealer subject to this section shall furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records of the member, broker or dealer that are

required to be preserved under this section, or any other records of the member, broker or dealer subject to examination under section 17(b) of the Act (15 U.S.C. 78q(b)) that are requested by the representative of the Commission.

(k) Records for the most recent two year period required to be made pursuant to Sec. 240.17a-3(f) and paragraphs (b)(4) and (e)(7) of this section which relate to an office shall be maintained at the office to which they relate. If an office is a private residence where only one associated person (or multiple associated persons who reside at that location and are members of the same immediate family) regularly conducts business, and it is not held out to the public as an office nor are funds or securities of any customer of the member, broker or dealer handled there, the member, broker or dealer need not maintain records at that office, but the records must be maintained at another location within the same State as the member, broker or dealer may select. Rather than maintain the records at each office, the member, broker or dealer may choose to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative.

(l) When used in this section:

(1) The term office shall have the meaning set forth in Sec. 240.17a-3(g)(1).

(2) The term principal shall have the meaning set forth in Sec. 240.17a-3(g)(2).

(3) The term securities regulatory authority shall have the meaning set forth in Sec. 240.17a-3(g)(3).

(4) The term associated person shall have the meaning set forth in Sec. 240.17a-3(g)(4).

Sec. 240.17a-4 [Amended]

6. Section 240.17a-4 is amended by:

a. Removing from paragraph (b)(7) the word ``his'' and in its place adding ``its'; and

b. Removing from paragraph (e)(1) the phrase ``the ``associated person'' has terminated his employment and any other connection with the member, broker or dealer.'' and in its place adding ``the associated person's employment and any other connection with the member, broker or dealer has terminated.''.

c. Removing from paragraph (f)(3)(ii) the phrase ``the Commission or its representatives'' and in its place adding ``the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer''.

d. Removing from paragraph (f)(3)(vii):

i. The phrase ``the U.S. Securities and Exchange Commission (``Commission''), its designees or representatives,'' and in its place adding ``the U.S. Securities and Exchange Commission (``Commission''), its designees or representatives, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer,'';

ii. The phrase ``the Commission's or designee's staff'' and in its place adding ``the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer''; and

iii. From each place it appears, the phrase ``the Commission's staff or its designee'' and in its place adding ``the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer''.

PART 242--REGULATIONS M and ATS

7. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78i(a), 78j, 78k-1(c), 78l, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 80a-23, 80a-29, and 80a-37.

8. In Sec. 242.303, paragraph (d) is amended by removing the phrase ``representatives or designees of the Securities and Exchange Commission, and to promptly furnish to the Commission or its designee'' and in its place adding ``the staff of the Securities and Exchange Commission, any self-regulatory organization of which the alternative trading system is a member, or any State securities regulator having jurisdiction over the alternative trading system, and to promptly furnish to the Commission, self-regulatory organization of which the alternative trading system is a member, or any State securities regulator having jurisdiction over the alternative trading system.''

Dated: October 26, 2001.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01-27439 Filed 11-1-01; 8:45 am]

BILLING CODE 8010-01-P

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

DRAFT

IN THE MATTER OF PROPOSED RULEMAKING TO AMEND A.A.C. R14-4-132.	DOCKET NO. RS-00000A-02-0005 DECISION NO. _____ **OPINION AND ORDER**

Open Meeting
August 29, 2002
Phoenix, Arizona

BY THE COMMISSION:

On April 10, 2002, the Securities Division ("Division") of the Arizona Corporation Commission ("Commission") forwarded to the Commission a proposal recommending that the Commission amend A.A.C. R14-4-132 ("rule 132"). Rule 132 requires that registered dealers make, maintain, and preserve books and records in compliance with certain specified U.S. Securities and Exchange Commission ("SEC") rules, including 17 CFR 240.17a-3 and 17 CFR 240.17a-4. The SEC has amended 17 CFR 240.17a-3 and 17 CFR 240.17a-4.

By Decision No. 64788 (May 1, 2002), the Commission directed that a Notice of Proposed Rulemaking be forwarded to the Office of the Secretary of State for publication in the Arizona Administrative Register. The Notice of Rulemaking Docket Opening was published in the register on February 1, 2002, and the Notice of Proposed Rulemaking was published on May 24, 2002. For at least thirty days after publication of the Notice of Proposed Rulemaking, the agency afforded persons the opportunity to submit comments, pursuant to A.R.S. § 41-1023(B). No written comments on rule 132 have been filed in this Docket. A written request for an oral proceeding was not submitted to the agency pursuant to A.R.S. § 41-1023(C).

DISCUSSION

By memorandum to the Hearing Division, the Division explained why rule 132 should be amended. The Division stated that while drafting the amendment to the rule, the Division solicited and received informal advice from both members of the securities regulation section of the Arizona State Bar and the Office of the Attorney General.

Rule 132 requires that registered dealers make, maintain, and preserve books and records in compliance with certain specified U.S. Securities and Exchange Commission ("SEC") rules, including 17 CFR 240.17a-3 and 17 CFR 240.17a-4. The SEC has amended 17 CFR 240.17a-3 and 17 CFR 240.17a-4. The amendments will be effective May 2, 2003.

The SEC's books and records rules, promulgated under the Securities Exchange Act of 1934, specify minimum requirements with respect to the records that dealers must make, and how long those records and other documents relating to a dealer's business must be kept. The SEC has required that dealers create and maintain certain records so that, among other things, the SEC, self-regulatory organizations, and state securities regulators may conduct effective examinations of dealers.

The National Securities Market Improvement Act of 1996 ("NSMIA") prohibits states from establishing books and records rules that differ from, or are in addition to, the SEC's books and records rules. Specifically, section 15(h)(1) of the federal Securities Exchange Act of 1934 (15 U.S.C. § 78o(h)(1)), adopted in NSMIA, provides that

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish . . . making and keeping records . . . requirements for . . . dealers . . . that differ from, or are in addition to, the requirements in those areas established under this title.

We believe that the amendment to rule 132 is in the public interest. Rule 132 as proposed will be in compliance with section 15(h)(1) of the Securities Exchange Act of 1934 and will enhance uniformity of compliance requirements for dealers. Rule 132 should be amended as proposed.

* * * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. On April 10, 2002, the Securities Division forwarded to the Commission a proposal recommending that the Commission amend rule 132.

2. On May 1, 2002, the Commission issued Decision No. 64788, which directed that a Notice of Proposed Rulemaking be forwarded to the Office of the Secretary of State for publication.

3. The Notice of Rulemaking Docket Opening was published in the Arizona Administrative Register on February 1, 2002, and the Notice of Proposed Rulemaking was published on May 24, 2002.

4. No member of the public requested an oral proceeding regarding the rule. No written comments concerning the rule were filed with the Commission.

5. Rule 132 requires that registered dealers make, maintain, and preserve books and records in compliance with certain specified U.S. Securities and Exchange Commission ("SEC") rules, including 17 CFR 240.17a-3 and 17 CFR 240.17a-4.

6. The SEC has amended 17 CFR 240.17a-3 and 17 CFR 240.17a-4. The amendments will be effective May 2, 2003.

7. Section 15(h)(1) of the federal Securities Exchange Act of 1934 (15 U.S.C. § 78o(h)(1)) provides that "No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish . . . making and keeping records . . . requirements for . . . dealers . . . that differ from, or are in addition to, the requirements in those areas established under this title."

8. Amendment to rule 132 is in the public interest, will be in compliance with section 15(h)(1) of the Securities Exchange Act of 1934, and will enhance uniformity of compliance requirements for dealers.

9. The rule is set forth in Exhibit A, attached and incorporated herein by reference.

10. The Economic, Small Business, and Consumer Impact Statement is set forth in Exhibit B, attached and incorporated by reference.

CONCLUSIONS OF LAW

1. Pursuant to A.R.S. § 44-1821 and the Arizona Constitution Article XV Section 4, the Commission has jurisdiction to amend A.A.C. R14-4-132.

2. Notice of and opportunity to comment on the amendment to rule 132 was given in the manner prescribed by law.

3. The amendment to rule 132 is reasonably necessary to carry out the provisions of the Arizona Securities Act.

4. The Economic, Small Business, and Consumer Impact Statement as set forth in Exhibit B should be adopted.

ORDER

IT IS THEREFORE ORDERED that A.A.C. R14-4-132, as set forth in Exhibit A, and the Economic, Small Business, and Consumer Impact Statement, as set forth in Exhibit B, are hereby adopted.

IT IS FURTHER ORDERED that the Division shall submit A.A.C. R14-4-132 to the Attorney General's Office for approval.

IT IS FURTHER ORDERED that the Division is authorized to make changes to the rule, A.A.C. R14-4-132, or the Economic, Small Business, and Consumer Impact Statement in response to comments received from the Attorney General's Office during the approval process under A.R.S. § 41-1044 unless, after notification of those changes, the Commission requires otherwise.

...

...

...

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _____ day of _____, 2002.

_____
BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT: _____

EXHIBIT A

R14-4-132. Books and Records of Dealers

A. Unless otherwise provided by order of the Commission, each registered dealer shall make, maintain, and preserve books and records in compliance with U.S. Securities and Exchange Commission rules 17a-3 (17 CFR 240.17a-3 (~~1991~~2002)~~,~~ and 17-a4 (17 CFR 240.17a-4 (~~1991~~2002)) as amended in Release No. 34-4992, 66 Fed. Reg. 55817 (2001);~~,~~ ~~15c2-6~~ 15g (17 CFR ~~240.15c2-6 (1991~~240.15g (2002))~~,~~; and 15c2-11 (17 CFR 240.15c2-11 (~~1991~~2002), ~~as amended in Release No. 34-29094, 56 Fed. Reg. 19148 (1991))~~ all of which are incorporated ~~herein~~ by reference. Copies of the materials are available from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402, from the Commission, and are on file with the office of the secretary of state.

B. To the extent that the U.S. Securities and Exchange Commission promulgates changes to the above-referenced rules, dealers in compliance with such rules as amended shall not be subject to enforcement action by the Commission for violation of this rule to the extent that the violation results solely from the dealer's compliance with the amended rule.